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2015

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### Recommended Citation

Thom Lambert and Alden F. Abbott, Recognizing the Limits of Antitrust: The Roberts Court Versus the Enforcement Agencies, 11 *Journal of Competition Law and Economics* 791 (2015).

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# RECOGNIZING THE LIMITS OF ANTITRUST: THE ROBERTS COURT VERSUS THE ENFORCEMENT AGENCIES

*Thomas A. Lambert*<sup>\*</sup> & *Alden F. Abbott*<sup>†</sup>

## ABSTRACT

In his seminal 1984 article, *The Limits of Antitrust*, Judge Frank Easterbrook proposed that courts and enforcers adopt a simple set of screening rules for application in antitrust cases, in order to minimize error and decision costs and thereby maximize antitrust's social value. Over time, federal courts in general—and the U.S. Supreme Court in particular, under Chief Justice Roberts—have in substantial part adopted Easterbrook's "limits of antitrust" approach, thereby helping to reduce costly antitrust uncertainty. Recently, however, antitrust enforcers in the Obama Administration (unlike their predecessors in the Reagan, Bush, and Clinton Administrations) have been less attuned to this approach, and have undertaken initiatives that reduce clarity and predictability in antitrust enforcement. Regardless of the cause of the diverging stances on the limits of antitrust, two things are clear. First, recent enforcement agency policies are severely at odds with the philosophy that informs Supreme Court antitrust jurisprudence. Second, if the agencies do not reverse course, acknowledge antitrust's limits, and seek to optimize the law in light of those limits, consumers will suffer.

*JEL*: L40; K21; O34; O38

## I. INTRODUCTION

Three decades ago, then-professor Frank H. Easterbrook published a law review article asserting the simple but profound point that antitrust law is inherently limited in what it can accomplish and should be implemented accordingly. Easterbrook's article, *The Limits of Antitrust*,<sup>1</sup> set forth a general prescription for maximizing antitrust's social value: in light of the inevitable social losses from incorrect antitrust decisions ("error costs") and the costs of assessing liability under the antitrust laws ("decision costs"), courts and regulators should interpret and enforce antitrust's amorphous prohibitions so as to

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<sup>1</sup> Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1 (1984).

minimize the sum of error and decision costs.<sup>2</sup> Easterbrook then posited a series of simple screening rules that, he argued, would maximize the net social benefits created by antitrust regulation.<sup>3</sup>

Without doubt, *The Limits of Antitrust* is one of the most influential antitrust articles ever penned. Cited in more than 550 law journal articles,<sup>4</sup> the piece helped launch what some have called a “Neo-Chicago” approach to antitrust analysis. Like its close cousin, the Chicago School of antitrust analysis, the Neo-Chicago approach emphasizes the robustness of markets and is skeptical of governmental efforts to correct for instances of market power. Neo-Chicagoans, though, have backed off of some of the Chicago School’s more extreme claims that certain practices can *never* be anticompetitive. The Neo-Chicago approach acknowledges that, under certain circumstances, anticompetitive harm may stem from a number of business practices; yet, it emphasizes that potential anticompetitive harm is only a necessary—never a sufficient—condition for antitrust intervention.<sup>5</sup> Following in Easterbrook’s footsteps, Neo-Chicagoans urge consideration of the tradeoffs associated with regulating versus not regulating.<sup>6</sup> They often conclude that the optimal policy is for antitrust to stay its hand even when the business practice under consideration legitimately threatens some anticompetitive harm.

This article assesses the extent to which Easterbrook’s “limits of antitrust” perspective, which has been so influential among antitrust scholars, has been adopted by the institutions holding the most sway over actual antitrust policy: the federal courts and the antitrust enforcement agencies.<sup>7</sup> The article

<sup>2</sup> *Id.* at 16.

<sup>3</sup> *Id.* at 17–39.

<sup>4</sup> See WESTLAW (Mar. 9, 2015), <https://www.westlaw.com>. A March 9, 2015 search of “Law Reviews and Journals” within the Westlaw database revealed 552 articles citing *The Limits of Antitrust*.

<sup>5</sup> See generally Daniel Crane, *Chicago, Post-Chicago, Neo-Chicago*, 76 U. CHI. L. REV. 1911, 1932–33 (2009) (describing a “Neo-Chicago” approach that would “rearticulat[e] [the Chicago School’s] second article of faith,” by emphasizing that “competitive practices that cause harm cannot be controlled without doing damage to similar competitive practices that do good” and that “the good that would be chilled through aggressive antitrust enforcement is often greater than the bad that would be prevented”); David S. Evans & A. Jorge Padilla, *Designing Antitrust Rules for Assessing Unilateral Practices: A Neo-Chicago Approach*, 72 U. CHI. L. REV. 73, 75 (2005) (defining a “neo-Chicago” approach that “accepts the Chicago tenet that legal rules” should be assessed “in terms of efficiency,” but also makes use of “post-Chicago insights in designing these rules”).

<sup>6</sup> Neo-Chicagoans reason that “market self-regulation is often superior to government regulation, which frequently is a solution in search of a problem.” See Gerald P. O’Driscoll, Jr. & Lee Hoskins, *The Case for Market-Based Regulation*, 26 CATO J. 469 (2006). They recognize that the costs of government failure may exceed those of market failure because, for example, regulators face informational constraints (see F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945)) and governmental officials’ pursuit of their own self interest may reduce overall social welfare (see, e.g., JAMES BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* (1965)).

<sup>7</sup> The Supreme Court has held that states may impose antitrust restrictions that are more restrictive than those set forth in the federal antitrust laws. See *Cal. v. ARC America Corp.*, 490 U.S. 93, 105 (1989). Many state restrictions are inconsistent with Easterbrook’s limits of

concludes that the federal judiciary—in particular, the U.S. Supreme Court under Chief Justice John Roberts—has largely endorsed Easterbrook’s limits of antitrust approach. By contrast, the Federal Trade Commission (FTC) and the Antitrust Division of the U.S. Department of Justice (DOJ) have been far less attuned to antitrust’s limits. In the end, the enforcement agencies’ failure to respect those limits is likely to hit judicial roadblocks and, if it continues, to injure consumers.

Part II of this article summarizes Easterbrook’s observations about the limits of antitrust and sets forth the overarching prescription that he advocates in light of those limits. Part III then evaluates the Roberts Court’s antitrust decisions involving vertical restraints, exclusionary conduct, and antitrust enforcement. Those decisions, Part III contends, are largely consistent with a limits of antitrust approach. Part IV considers a number of areas in which the antitrust enforcement agencies have recently ignored—or at least downplayed—the limits of antitrust, most likely to the detriment of consumers. Part V concludes.

## II. ANTITRUST, ITS LIMITS, AND THE OPTIMAL APPROACH TO DESIGNING LIABILITY RULES

When it comes to ensuring that consumers have access to lower-priced and higher-quality goods and services, there is no better regulator than market competition. The purpose of the antitrust laws then is to promote vigorous competition among market participants. That does not imply, though, that antitrust should try to maximize the number of competitors in a market or prevent competitors from ever cooperating. Many markets exhibit economies of scale, such that larger competitors produce at a lower per-unit cost than their smaller rivals. If antitrust broke up large firms so that they could never achieve the “minimum efficient scale” (that is, the point beyond which an increase in output does not reduce per-unit costs),<sup>8</sup> production costs, and thus prices, would be higher than necessary. In some markets, a few firms operating at the minimum efficient scale can meet all consumer demand. Breaking up large firms to create additional competitors in those markets would harm consumers. Similarly, forbidding competitors from ever cooperating could harm consumers by thwarting joint ventures that reduce costs, enhance quality, and increase product variety. Consequently, in its quest to ensure competition, antitrust should eschew simple mantras like “big is bad” and “cooperation among competitors is unacceptable.” Instead, antitrust should (and modern antitrust generally does) embrace an *output-focused* understanding of competition, where markets are deemed more competitive when they produce more of

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antitrust approach and, accordingly, are likely to occasion consumer harm. Analysis of such restrictions, however, is beyond the ambit of this article.

<sup>8</sup> Minimum efficient scale is the lowest production point at which long-run average costs are minimized. See HAL R. VARIAN, *INTERMEDIATE MICROECONOMICS* 428 (1987).

what consumers want, and at lower prices, and less competitive when they produce less, and at higher prices.<sup>9</sup> The chief goal of antitrust is and should be to maximize competition, so understood.

Antitrust generally accomplishes this task by policing the two scenarios in which competition breaks down. One is collusion, a situation in which nominal competitors agree not to compete. The other is monopoly (or monopsony), a state of affairs in which there is a single significant seller (or buyer). The two most important provisions of the federal antitrust laws correspond to those two paradigmatic defects in competition. Section 1 of the Sherman Act addresses collusion, proclaiming that “[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce ... is declared to be illegal.”<sup>10</sup> Section 2 addresses monopoly, making it illegal to “monopolize, or attempt to monopolize, or combine or conspire ... to monopolize” any market.<sup>11</sup>

From the outset, these statutory texts have proven challenging for courts. Interpreted literally, section 1 leads to an absurd result. The very essence of a contract is to commit the parties to some course of action, thereby “restraining” them from exchanges that are inconsistent with that course. A ban on “[e]very contract ... in restraint of trade” would cover virtually all contracts.<sup>12</sup> Recognizing as much, courts have long interpreted section 1 to forbid only agreements that *unreasonably* restrain trade.<sup>13</sup>

Section 2 has posed a similar difficulty and engendered a similar judicial solution. Section 2 wisely avoids forbidding monopoly itself, for many monopolies result from one firm offering a superior product that usurps business from its rivals. Because shooting the winner is hardly the way to encourage vigorous competition, section 2 prohibits not monopoly but *monopolization*, which has been interpreted to require “exclusionary” conduct.<sup>14</sup> However, all

<sup>9</sup> We refer here to *quality-adjusted* output. Therefore, a market development causing a slight decrease in the number of units sold could be deemed procompetitive if it resulted in goods of substantially higher quality (for which consumers would be willing to pay more).

<sup>10</sup> 15 U.S.C. § 1. Clayton Act, section 7, perhaps the third most important provision of the federal antitrust laws, similarly addresses agreements not to compete. That provision forbids any business combination (for example, merger) whose effect “may be substantially to lessen competition” in “any line of commerce.” 15 U.S.C. § 18.

<sup>11</sup> 15 U.S.C. § 2.

<sup>12</sup> See *Board of Trade v. United States*, 246 U.S. 231, 238 (1918) (reasoning that the term “restraint of trade” in Section 1 cannot possibly refer to any restraint on competition, for “[e]very agreement concerning trade, every regulation of trade, restrains” and because “[t]o bind, to restrain, is of their very essence”).

<sup>13</sup> *Id.* (“The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition.”).

<sup>14</sup> The elements of monopolization are “(1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.” See *United States v. Grinnell Corp.*, 384 U.S. 563, 570–71 (1966). The latter

sorts of proconsumer business conduct is literally exclusionary. Building a better mousetrap, or lowering the price on its existing mousetrap, will enable a mousetrap manufacturer to gain additional business and thereby tend to exclude rival mousetrap manufacturers. Courts have therefore interpreted the exclusionary conduct element of the monopolization offense to require *unreasonably* exclusionary conduct. The upshot of these interpretive developments is that courts confronting antitrust challenges to novel business practices must regularly make judgments about the overall desirability of the practices at issue. In forming those judgments, they must ask such questions as, for example, does the challenged practice constitute an “unreasonable” restraint of trade? Is it “unreasonably” exclusionary?

The enforcement provisions of the antitrust laws guarantee that courts are routinely called upon to decide such matters in private lawsuits. Section 4 of the Clayton Act enables “any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws” to sue for damages in federal court.<sup>15</sup> Moreover, a successful plaintiff is entitled not merely to compensatory damages. Because many antitrust violations occur in secret and are not successfully prosecuted, the Clayton Act seeks to optimize deterrence by allowing a plaintiff to “recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney’s fee.”<sup>16</sup>

In the end, then, antitrust consists of a body of law that attempts to maximize competition (understood in terms of long-run quality-adjusted market output),<sup>17</sup> is quite general in its literal prohibitions, becomes “fleshed out” by generalist courts adjudicating largely private disputes, and is highly attractive to private plaintiffs (and plaintiffs’ lawyers) seeking treble damages. Taken together, these features constrain the social value antitrust regulation can ultimately create. To see why that is so, consider the difficulties facing antitrust adjudicators and the costs those difficulties produce.

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element is usually referred to as “exclusionary” conduct. *See, e.g.,* PHILLIP E. AREEDA & HERBERT HOVENKAMP, 3 ANTITRUST LAW ¶ 681 (3d ed. 2008) (“The § 2 monopolizing offense requires something more than the existence of monopoly power; the ‘something more’ is generally referred to as an ‘exclusionary practice.’”).

<sup>15</sup> 15 U.S.C. § 15.

<sup>16</sup> *Id.*

<sup>17</sup> Antitrust aims to maximize market output *in the long run*. Numerous antitrust doctrines—such as the rule that charging a monopoly price is not, in itself, illegal—confirm that antitrust is focused on dynamic, long-run effects. *See* Verizon Commc’ns, Inc. v. Law Offices of Curtis V. Trinko, 540 U.S. 398, 407 (2004). Monopoly pricing, after all, results in an immediate reduction in market output. Nevertheless, a monopolist that has attained its monopoly legitimately may charge monopoly prices because, as the Supreme Court has observed, the prospect of charging monopoly prices tends to encourage innovation and thereby enhance long-term market output. *See id.* (“[T]he ... charging of monopoly prices, is not only not unlawful; it is an important element of the free market system. The opportunity to charge monopoly prices—at least for a short period—is what attracts ‘business acumen’ in the first place; it induces risk taking that produces innovation and economic growth.”).

The first thing to note is that antitrust adjudication poses hard questions. Challenges to concerted conduct—potential collusion—are often perplexing because many output-enhancing business arrangements (for example, joint ventures) involve cooperation among independent economic actors, often competitors. Adjudicators must determine whether the coordinated arrangement at issue is likely to increase market output, in which case the trade-restraining agreement is reasonable, or reduce it, in which case the requisite unreasonableness exists. In monopolization and attempted monopolization cases, adjudicators must determine if conduct that won business for the defendant vis-à-vis its rivals was just vigorous competition or crossed into unreasonable exclusion territory. To draw the necessary distinctions, judges and juries generally must assess conflicting testimony from economic experts and reach conclusions on such complicated subsidiary issues as the contours of the relevant market, the existence and size of entry barriers, and the elasticities of demand and supply for the product at issue.

There are thus significant costs in simply *reaching a decision* as to whether a particular conduct violates the antitrust laws. If the conduct is challenged in court, the parties themselves, with the aid of lawyers and economic experts, must gather, process, and present a large amount of complex data. The jury or judge must then deliberate over the information presented and decide both subsidiary issues (for example, what exactly is the relevant market?) and the outcome-determinative question (for example, is the conduct “unreasonably” exclusionary?). Even before any court challenge, business planners must assess the likelihood that their contemplated conduct may be deemed to violate the antitrust laws. Taken together, the costs that business planners, litigating parties, and adjudicators face in assessing and establishing the legality or illegality of a practice constitute antitrust’s “decision costs.”

Those are not the only costs associated with antitrust adjudication. Given the difficulty of distinguishing collusion from output-enhancing cooperation and unreasonably exclusionary conduct from vigorous competition, adjudicators will certainly make mistakes in deciding antitrust cases. Those mistakes, then, will themselves impose social costs. A mistaken acquittal of an anticompetitive practice—a false negative or “Type II error”—will tend to permit market power that causes resources to be allocated away from their highest and best uses.<sup>18</sup> A mistaken conviction of a procompetitive practice—a false positive or “Type I error”—will squander social welfare by denying market participants the benefit of the efficient, wrongly condemned business practice. The

<sup>18</sup> Firms with market power are not constrained by competition into providing the maximum level of value for consumers. They tend to allocate productive resources in a manner that maximizes their profits but not overall social welfare. See generally HERBERT HOVENKAMP, *FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE* 19–26 (3d ed. 2005). Such an “allocative inefficiency” is the primary adverse effect antitrust seeks to prevent.

latter sort of error is likely to be more damaging in the long run.<sup>19</sup> Whereas market power, the result of a Type II error, tends to self-correct as firms enter the market and expand output in response to higher prices, judicial condemnation of an efficient practice will have economy-wide, not just market-wide, effects and may be corrected only by a subsequent judicial decision or a legislative fix.<sup>20</sup> Nevertheless, both false convictions and false acquittals tend to reduce social welfare, imposing “error costs.”

Taken together, antitrust’s decision and error costs comprise, in Easterbrook’s words, “the limits of antitrust.”<sup>21</sup> They ultimately constrain what the body of law can accomplish because they are in inexorable tension: efforts to reduce one type of cost will tend to raise another. For example, courts cannot streamline the factual inquiry required to assess whether some practice should give rise to antitrust liability, thereby lowering decision costs, without increasing the likelihood of error and thus error costs. If they try to reduce the risk of false conviction (Type I error) by making it harder for a plaintiff to establish liability or easier for a defendant to make out a defense, they will increase the likelihood of false acquittal (Type II error). And if they ease a plaintiff’s burden or cut back on available defenses in order to reduce false acquittals, they will tend to enhance social losses from false convictions. As in a game of whack-a-mole, hammering down costs in one area will just cause them to turn up elsewhere.

In light of this unhappy situation, Easterbrook contended, tribunals should give up trying to eliminate antitrust’s inevitable and inexorable decision costs and error costs and should instead attempt to *optimize* antitrust—that is, to craft liability and procedural rules aimed at minimizing the sum of decision and error costs.<sup>22</sup> Doing so will require tribunals to account for several factors. A proffered rule’s error costs are a function of both the probability that it will lead to an incorrect judgment and the magnitude of loss that will result from

<sup>19</sup> As Easterbrook pointed out,

[T]he conditions for useful legal intervention may be met when we know a lot about the practice and can condemn or approve it out of hand. But when we know but little the risk of error goes up, and the risk of false positives may be substantial. People are quick to condemn what they do not understand. Hasty or uninformed judgments may condemn novel practices just because of their novelty. Often it takes a decade or more to determine what a business practice really does. The law moves too fast for our own good, because courts act in advance of the explanation. Judges move slower than markets but faster than the economics profession, a deadly combination.

Frank H. Easterbrook, *Does Antitrust Have a Comparative Advantage?*, 23 HARV. J. L. & PUB. POL’Y 5, 8–9 (1999).

<sup>20</sup> See Easterbrook, *supra* note 2, at 2–3 (contending that false convictions create greater social loss than false acquittals).

<sup>21</sup> Easterbrook, *supra* note 1, at 4.

<sup>22</sup> *Id.* at 16 (“The legal system should be designed to minimize the total costs of (1) anticompetitive practices that escape condemnation, (2) competitive practices that are condemned or deterred, and (3) the system itself.”).



that sort of error.<sup>23</sup> Its decision costs are a function of its informational requirements and the ease with which it can be applied. An optimizing approach, then, would account for (1) the likelihood that the proposed liability rule will produce an incorrect judgment, (2) the magnitude of losses from the various errors that the rule might generate, and (3) the difficulty of administering the rule.<sup>24</sup> By carefully considering these factors and crafting liability rules calculated to minimize the sum of decision and error costs, tribunals could ensure that the inherently limited antitrust enterprise generates as much social value as possible.

So how have the courts and enforcement agencies fared in harnessing Easterbrook's insights to maximize antitrust's social value? The Roberts Court seems largely to have recognized antitrust's limits and adopted rules consistent with Easterbrook's overarching policy prescription. On the other hand, the enforcement agencies, at least in recent years, have taken a number of positions at odds with a limits of antitrust approach.

### III. THE ROBERTS COURT'S RECOGNITION OF THE LIMITS OF ANTITRUST

Since its early days,<sup>25</sup> the Roberts Court has taken quite an interest in antitrust. Whereas the Rehnquist Court decided one antitrust case from 1993 to 1995, one each year from 1996 through 1999, and none from 2000 to 2003, the Roberts Court decided seven antitrust cases in 2006 and 2007 alone. This part examines the Roberts Court's decisions addressing vertical restraints of trade, exclusionary conduct, and antitrust enforcement. It concludes that each is consistent with an effort to limit the sum of antitrust's error and decision costs.<sup>26</sup>

#### A. Vertical Restraints

Courts originally viewed vertical restraints of trade—trade-limiting agreements between economic actors at different stages of the distribution process (for

<sup>23</sup> Specifically, if  $P$  = the probability of an error, and  $M$  = the expected magnitude of loss from that sort of error, then a proposed rule's error costs =  $(P_{\text{false positive}} \times M_{\text{false positive}}) + (P_{\text{false negative}} \times M_{\text{false negative}})$ .

<sup>24</sup> Specifically, a tribunal should select the liability rule generating the lowest possible solution to the following formula: Decision Costs +  $[(P_{\text{false positive}} \times M_{\text{false positive}}) + (P_{\text{false negative}} \times M_{\text{false negative}})]$ .

<sup>25</sup> Then Circuit Judge John Roberts became Chief Justice of the United States Supreme Court on September 29, 2005. See David Stout, *Roberts Is Sworn in as Chief Justice of the U.S.*, N.Y. TIMES, Sept. 29, 2005, at 1A.

<sup>26</sup> In addition to the antitrust decisions discussed here, the Roberts Court has decided three cases involving horizontal restraints of trade. As one of us has elsewhere explained, two of those decisions—*Texaco Inc. v. Dagher* (547 U.S. 1 (2006)) and *American Needle, Inc. v. NFL* (560 U.S. 183 (2010))—are consistent with an effort to minimize the sum of antitrust's error costs and decision costs. See Thomas A. Lambert, *The Roberts Court and the Limits of Antitrust*, 52 B.C.L. REV. 871, 906–09, 920–28 (2011). The third decision involving horizontal restraints, *FTC v. Actavis* (133 S. Ct. 2223 (2013)) is admittedly difficult to square with a limits of antitrust approach. The position espoused in the dissent by Chief Justice Roberts seems to fit better with Easterbrook's overarching policy prescription.

example, between a manufacturer and a retailer)—with great suspicion. Under what came to be known as the “inhospitality tradition,” such restraints were strictly policed under section 1 of the Sherman Act.<sup>27</sup> The U.S. Supreme Court’s *Dr. Miles* decision, for example, declared “minimum resale price maintenance” (RPM)—an arrangement in which a downstream seller agrees to charge a minimum resale price for a manufacturer’s product—to be *per se* illegal.<sup>28</sup> RPM is an “intradbrand” vertical restraint because the manufacturer is placing restraints on downstream trades of its own brand. Other decisions strictly regulated “interbrand” vertical restraints, arrangements in which a producer somehow restrains downstream trades in *other* brands. One such restraint is tying (or a “tie-in”), which involves a commitment by a purchaser of one product (the “tying” product) also to buy from the seller a second product (the “tied” product). A tie-in has the effect of restraining the purchaser from buying other brands of the tied product. The U.S. Supreme Court has long held that tying is *per se* illegal if the tie-in involves two separate products, the producer possesses market power over the tying product, and the tie-in affects a not insubstantial dollar volume of commerce in the tied product market.<sup>29</sup> In its 1984 *Jefferson Parish* decision, the Court suggested in dictum that the

<sup>27</sup> See Alan J. Meese, *Raising Rivals’ Costs: Can the Agencies Do More Harm Than Good?*, 12 GEO. MASON L. REV. 241, 260 n.98 (2003). The term was apparently coined by Donald Turner, who headed the Antitrust Division of the U.S. Department of Justice in the 1960s. See Donald F. Turner, *Some Reflections on Antitrust*, 1966 N.Y. ST. B.A. ANTITRUST L. SYMP. 1, 1–2 (“I approach territorial and customer restrictions not hospitably in the common law tradition, but inhospitably in the tradition of antitrust law.”).

<sup>28</sup> *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373, 400 (1911). *Dr. Miles* was just the first in a long string of decisions displaying a hostility toward vertical restraints. In *United States v. Arnold, Schwinn & Co.* (388 U.S. 365 (1967)) the Supreme Court declared vertical *non-price* restraints—such as a manufacturer’s requirement that its dealers sell only in certain geographic territories or to particular customers—to be *per se* illegal. The following year, in *Albrecht v. Herald Co.* (390 U.S. 145 (1968)) the Court declared *maximum* RPM to be *per se* illegal. With respect to “interbrand” vertical restraints (defined in the text following this note), the Court initially adopted a rule of near *per se* illegality for exclusive dealing arrangements involving more than a small amount of market foreclosure. See *Standard Oil of Cal. v. United States*, 337 U.S. 293 (1949) (condemning exclusive dealing arrangement that foreclosed defendant’s rivals from 6.7 percent of marketing outlets). The Court also adopted a “quasi-*per se* rule” (discussed *infra* at note 28 and accompanying text) against tying. See *Fortner Enterprises, Inc. v. U.S. Steel Corp.*, 394 U.S. 495 (1969). By the time of Chief Justice Roberts’ ascension, the Court had liberalized the rules governing all vertical restraints except minimum RPM, which remained subject to the rule of *Dr. Miles*, and tying, which is still subject to the quasi-*per se* rule. See *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 9 (1984) (“It is far too late in the history of our antitrust jurisprudence to question the proposition that certain tying arrangements pose an unacceptable risk of stifling competition and therefore are unreasonable *per se*.”). Notably, a number of states remain inhospitable to vertical restraints. See, e.g., John R. Foote & Blair Z. Russell, *Resale Price Maintenance: Per se Antitrust Treatment Alive in the States*, 27 WASHINGTON LEGAL FOUNDATION LEGAL BACKGROUNDER (Oct. 19, 2012), [http://www.wlf.org/upload/legalstudies/legalbackgrounder/10-19-12Foote\\_LegalBackgrounder.pdf](http://www.wlf.org/upload/legalstudies/legalbackgrounder/10-19-12Foote_LegalBackgrounder.pdf).

<sup>29</sup> See, e.g., *Fortner Enterprises, Inc. v. U.S. Steel Corp.* (Fortner I), 394 U.S. 495, 501, 503 (1969); *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451, 461–62 (1992).

market power element of this “quasi-*per se* rule” is satisfied if the tying product is subject to a patent.<sup>30</sup> The upshot was that any producer who sold a patented product on the condition that a buyer also purchase some other product was in danger of antitrust liability.

The error costs stemming from *Dr. Miles* and the *Jefferson Parish* dictum were significant. Economists have long understood that minimum RPM, *per se* illegal under *Dr. Miles*, may be employed for a number of output-enhancing ends: to prevent discount dealers from free-riding on high-service (and, thus, higher-priced) dealers’ demand-enhancing services,<sup>31</sup> to facilitate entry of new brands by guaranteeing a certain retail mark-up to pioneer retailers,<sup>32</sup> and to encourage dealers to use their own initiative to promote the producer’s (high-margin) brand over rival brands.<sup>33</sup> The circumstances in which RPM may achieve these output-enhancing purposes are quite common. By contrast, the pre-conditions to RPM’s potential anticompetitive harms—facilitation of manufacturer or retailer cartels and exclusion of competition by dominant manufacturers or retailers—rarely exist.<sup>34</sup> Not surprisingly, then, the empirical evidence on RPM has suggested that it is more often procompetitive (output-enhancing) than anticompetitive (output-reducing).<sup>35</sup> The old rule of *Dr. Miles*, dutifully followed for nearly a century, therefore injured consumers by creating large Type I error costs (that is, losses from false convictions of procompetitive conduct).

*Jefferson Parish*’s presumption that possession of a patent on a tying product creates the market power necessary for *per se* illegality similarly generated huge error costs. As an initial matter, it is now well-understood that tie-ins are not,

<sup>30</sup> See *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 16 (1984) (observing that “if the Government has granted the seller a patent or similar monopoly over a product, it is fair to presume that the inability to buy the product elsewhere gives the seller market power”).

<sup>31</sup> See Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86, 91–93 (1960); see also Robert Bork, *The Rule of Reason and the Per Se Concept: Price-Fixing and Market Division (Part II)*, 75 YALE L.J. 373 (1966).

<sup>32</sup> See Kenneth G. Elzinga & David E. Mills, *The Economics of Resale Price Maintenance*, in 3 ISSUES IN COMPETITION LAW AND POLICY 1841, 1848 (Wayne D. Collins ed., 2008) (“To secure entry, a new entrant may seek to gain retail distribution by offering independent retailers protections against discounting, in the hope that margin protection will induce retailers to market and promote the new product.”).

<sup>33</sup> See Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J.L. & ECON. 265 (1988).

<sup>34</sup> See Thomas A. Lambert, *A Decision-Theoretic Rule of Reason for Minimum Resale Price Maintenance*, 55 ANTITRUST BULL. 167, 174–76 (2010) (summarizing RPM’s potential anticompetitive harms); *id.* at 181–84 (cataloguing prerequisites to potential anticompetitive harms from RPM).

<sup>35</sup> See generally Thomas A. Lambert, *Dr. Miles Is Dead. Now What?: Structuring a Rule of Reason for Evaluating Minimum Resale Price Maintenance*, 50 WM. & MARY L. REV. 1937, 1989–92 (2009) (summarizing empirical evidence on RPM’s competitive effects); see also Pauline M. Ippolito, *Resale Price Maintenance: Empirical Evidence from Litigation*, 34 J.L. & ECON. 263 (1991); Stanley I. Ornstein, *Resale Price Maintenance and Cartels*, 30 ANTITRUST BULL. 401, 431 (1985); THOMAS R. OVERSTREET, JR., *RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE* (1983).

as the Supreme Court once believed, always or almost always anticompetitive.<sup>36</sup> Indeed, tie-ins might (1) help protect the tying product's quality and reputation (by ensuring that only high-quality complements are used);<sup>37</sup> (2) facilitate output-enhancing price discrimination (as heavy users of the tying product effectively pay more by buying more of the tied complement, thereby enabling the seller to charge lower prices for the tying product so that consumers with a lower willingness-to-pay enter the market);<sup>38</sup> and (3) enable producers to evade rate regulation on the tying product by imposing a tie-in and then hiking the price of that product (such regulation is often, though not always, output-reducing).<sup>39</sup> Tie-ins threaten real anticompetitive harm only when they result in a substantial foreclosure of sales opportunities to rivals in the tied product market.<sup>40</sup> Because that situation rarely exists and is easily identified, the quasi-*per se* rule against tying is itself unwise and should be replaced with a more probing Rule of Reason that assesses whether the particular tie-in at issue is likely to reduce rather than enhance overall market output.

Even if some sort of *per se* rule against tying by those possessing market power were appropriate, the presumption that the mere possession of a patent on a tying product confers tying market power is ludicrous. Most patents confer no market power.<sup>41</sup> Given the huge percentage of products incorporating some

<sup>36</sup> See Thomas A. Lambert, *Appropriate Liability Rules for Tying and Bundled Discounting*, 72 OHIO ST. L.J. 909, 934–58 (2011) (discussing economics of tying).

<sup>37</sup> See, e.g., Margaret E. Slade, *The Leverage Theory of Tying Revisited: Evidence from Newspaper Advertising*, 65 SO. ECON. J. 204, 208 (1998); William E. Baxter & Daniel P. Kessler, *Toward a Consistent Theory of the Welfare Analysis of Agreements*, 47 STAN. L. REV. 615, 621 (1995); RICHARD A. POSNER & FRANK H. EASTERBROOK, ANTITRUST CASES, ECONOMIC NOTES, AND OTHER MATERIALS 808–09 (1981); ROBERT H. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF 379–80 (1978). But see Edward M. Iacobucci, *Tying as Quality Control: A Legal and Economic Analysis*, 32 J. LEGAL STUDS. 435 (2003) (questioning quality-control rationales for tying).

<sup>38</sup> See Benjamin Klein & John Shepard Wiley, Jr., *Competitive Price Discrimination as an Antitrust Justification for Intellectual Property Refusals to Deal*, 70 ANTITRUST L.J. 599, 612–13 (2002); Lambert, *supra* note 35, at 935–50.

<sup>39</sup> See Herbert Hovenkamp, *Tying Arrangements and Class Actions*, 36 VAND. L. REV. 213, 234 (1983) (“Tying arrangements in price-regulated industries may be efficiency creating.”); Thomas B. Leary, Commissioner, Fed. Trade Comm’n, *Antitrust Law as a Balancing Act Address* (Dec. 17, 1999), <http://www.ftc.gov/speeches/leary/leary991217.shtm> (discussing the use of tie-ins to evade price regulation and observing that “[w]hile regulatory evasion [via tying] may supply the motive for particular conduct that may be otherwise inexplicable, it does not constitute independent evidence of competitive harm”).

<sup>40</sup> See Lambert, *supra* note 35, at 926–62.

<sup>41</sup> See WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF INTELLECTUAL PROPERTY LAW 374 (2003); Kenneth J. Burchfiel, *Patent Misuse and Antitrust Reform: “Blessed Be the Tie?”*, 4 HARV. J.L. & TECH. 1, 57, 57 n.340 (1991) (observing that presumption of market power from possession of patent has been extensively criticized and citing sources); see also U.S. DEPARTMENT OF JUSTICE AND U.S. FEDERAL TRADE COMMISSION, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY 4 (1995), <http://www.justice.gov/atr/public/guidelines/0558.pdf> (“[t]he [federal antitrust] [a]gencies will not presume that a [p]atent . . . necessarily confers market power upon its owner.”).

patented feature, a rule deeming patents to confer market power effectively renders many or most tie-ins *per se* illegal. And since tie-ins are usually procompetitive rather than anticompetitive, such a rule generates tremendous error cost.

In its early days, the Roberts Court took steps to stem the error costs flowing from both *Jefferson Parish's* improvident dictum and the holding of *Dr. Miles*. In its 2006 *Independent Ink* decision, the Court addressed tying.<sup>42</sup> Recognizing that many patents confer no market power whatsoever,<sup>43</sup> it held that the mere possession of a patent covering the tying product cannot establish the market power necessary to render a tie-in *per se* illegal.<sup>44</sup> Perhaps more significantly, the Court expressly acknowledged that the use of tying to achieve price discrimination, which is often output-enhancing,<sup>45</sup> is not inherently suspect.<sup>46</sup> The following year, the Court addressed minimum RPM. Its 2007 *Leegin* decision held that the practice, which offers a number of procompetitive benefits, would no longer be *per se* illegal but must instead be evaluated under the Rule of Reason.<sup>47</sup>

By constraining the scope of one highly error-prone *per se* rule (that against tying) and altogether overruling another (that against minimum RPM), the Court substantially reduced the error costs occasioned by antitrust's rules on vertical restraints. Because that error-cost reduction would likely dwarf any increase in decision costs, *Independent Ink* and *Leegin* are wholly consistent with Easterbrook's directive.<sup>48</sup>

## B. Exclusionary Conduct

The Roberts Court has decided two cases involving unilateral conduct alleged to be unreasonably exclusionary in violation of section 2 of the Sherman Act. In each, the Court embraced clear, administrable liability rules that are likely to reduce the sum of error and decision costs.

The issue in the Court's *Weyerhaeuser* decision was what standard should govern "predatory bidding" claims.<sup>49</sup> In a predatory bidding case, a buyer bids up the price of some input higher than the level necessary to acquire all the buyer needs. Its purpose in doing so is to drive out rival input buyers who cannot afford to pay the higher input price. Once rival buyers are eliminated, the bidder may gain monopsony power (buyer-side market power), enabling it

<sup>42</sup> *Ill. Tool Works, Inc. v. Indep. Ink, Inc.*, 547 U.S. 28 (2006).

<sup>43</sup> *Id.* at 44 (observing that "the vast majority of academic literature recognizes that a patent does not necessarily confer market power").

<sup>44</sup> *Id.* at 31.

<sup>45</sup> See Lambert, *supra* note 35, at 935–50.

<sup>46</sup> *Independent Ink*, 547 U.S. at 43–45.

<sup>47</sup> *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 886–87 (2007).

<sup>48</sup> See generally Lambert, *supra* note 25, at 880–91, 902–06 (explaining how holdings of *Leegin* and *Independent Ink* help minimize sum of error and decision costs).

<sup>49</sup> *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.*, 549 U.S. 312 (2007).

to drive input prices below competitive levels.<sup>50</sup> The issue before the Court was whether plaintiffs complaining of predatory bidding should be required to show (1) that the defendant's bidding behavior caused its output to be priced below cost (given the inflated prices the defendant paid for inputs), and (2) that the defendant could likely recoup its losses from below-cost output prices by paying monopsonistic (artificially low) prices after driving out rival input buyers.<sup>51</sup> The Court of Appeals had rejected that rule,<sup>52</sup> which mirrors the liability rule that the Supreme Court adopted for predatory pricing in its *Brooke Group* decision.<sup>53</sup> The lower court instead approved a jury instruction that would have imposed liability had the defendant "purchased more [inputs] than it needed or paid a higher price for [inputs] than necessary, in order to prevent [rival buyers] from obtaining the [inputs] they needed at a fair price."<sup>54</sup>

In reversing the Court of Appeals and endorsing the two-part liability rule set forth above, the Court expressly invoked concerns about error costs. It began by observing that the analogous *Brooke Group* liability rule for predatory pricing was itself premised not on a belief that low but above-cost pricing can never be anticompetitive,<sup>55</sup> but instead on a desire to avoid error costs from false convictions of procompetitive discounting:

The first prong of the [*Brooke Group*] test—requiring that prices be below cost—is necessary because “[a]s a general rule, the exclusionary effect of prices above a relevant measure of cost either reflects the lower cost structure of the alleged predator, and so represents competition on the merits, or is beyond the practical ability of a judicial tribunal to control.” We were

<sup>50</sup> See *id.* at 320–21 (explaining strategy behind predatory bidding).

<sup>51</sup> *Id.* at 317–18.

<sup>52</sup> *Confederated Tribes of Siletz Indians v. Weyerhaeuser Co.*, 411 F.3d 1030, 1035–36 (9th Cir. 2005).

<sup>53</sup> See *Brooke Grp. Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 222, 224 (1993) (holding that plaintiff complaining of predatory pricing must establish that (1) “the prices complained of [were] below an appropriate measure of its [defendant] rival’s costs,” and (2) there was a “dangerous probability” at the time of the below-cost pricing that the rival would eventually “recoup[] its investment” in the predation by charging supracompetitive prices).

<sup>54</sup> *Weyerhaeuser*, 549 U.S. at 317 (stating jury instruction lower court had approved).

<sup>55</sup> It is well understood that so-called “limit” pricing, which occurs when a firm with market power sets its prices above its costs but below the profit-maximizing level so as to deter entry, can be anticompetitive. See HERBERT HOVENKAMP, *THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION* 161–62 (2005). Whereas such pricing may impose competitive harm and injure consumers in the long run, it is simply too difficult for antitrust tribunals to police. As Herbert Hovenkamp has observed, “No court has ever developed a workable test for determining when an above-cost price is anticompetitive.” *Id.* at 162. Moreover, there is the problem of fashioning a remedy. Forcing the defendant to raise its price to the monopoly level to invite new entry poses serious risks to consumers if, for example, entry does not occur instantly. Alternatively, forcing the defendant to lower its price to competitive levels would make eventual entry even less likely and would “put the court in the position of a regulatory agency, constantly monitoring the dominant firm’s prices to ensure that they stayed near the competitive level.” *Id.*

particularly wary of allowing recovery for above-cost price cutting because *allowing such claims could, perversely, “chill[] legitimate price cuttings,”* which directly benefits consumers.<sup>56</sup>

The Court then observed that bidding up the price of inputs, like lowering the price of one’s output, might occur for “myriad legitimate reasons—ranging from benign to affirmatively procompetitive.”<sup>57</sup> To avoid chilling non-harmful instances of aggressive input buying or bidding, the Court reasoned, the liability rule should include a safe harbor for any input bidding that an equally efficient output producer could match. If the defendant’s output was still priced above the defendant’s cost even after the defendant had bid up input prices, then any equally efficient output producer could match the purportedly inflated input price and should not be excluded by the bidding behavior. Thus, the Court concluded, a predatory bidding plaintiff should have to prove that the complained of bidding resulted in below-cost pricing in the output market.<sup>58</sup> Not only would this rule reduce error costs by providing a safe harbor for procompetitive input-bidding, it would also lower decision costs. After all, the alternative rule imposing liability if a defendant “purchased more [inputs] than necessary, in order to prevent [input market rivals] from obtaining the [inputs] they needed at a fair price”<sup>59</sup> would open the door to long and costly expeditions to establish the number of inputs “needed,” the price “necessary” to obtain such a quantity, the motives of the defendant in making its bids, and the “fair” price that should have been guaranteed to the defendant’s rivals. *Weyerhaeuser* thus had the effect of lowering the sum of error and decision costs in predatory bidding cases.

Soon after deciding *Weyerhaeuser*, the Court applied Easterbrook’s directive to so-called “price squeezes.” Suppose that a firm (1) sells both some finished product (for example, fabricated aluminum pieces) and an input that goes into creating that product (for example, aluminum ingot), and (2) possesses monopoly power in the input (upstream) market. If such a “vertically integrated monopolist” were simultaneously to raise the price of its input and lower, or perhaps hold constant, its price in the output (downstream) market, then it could “squeeze” the profit margins of its downstream market rivals; they would have no choice but to buy its high-priced input, yet would be constrained from raising their output prices. In an early and famous monopolization decision,

<sup>56</sup> *Id.* at 319 (second and third alterations in original) (emphasis added) (citations omitted) (quoting *Brooke Grp.*, 509 U.S. at 223).

<sup>57</sup> *Id.* at 323. For example, a firm buying up inputs in a manner that increases their price might (1) simply miscalculate its input needs; (2) anticipate increased consumer demand for its output; (3) face different efficiencies than its input market rivals (for example, it may be able to extract greater value from the input, which would cause it to value the input more, or it may use a particularly input-intensive production process, which would cause it to have greater input needs); or (4) seek to acquire excess inputs as a hedge against future price increases. *Id.*

<sup>58</sup> *Id.* at 325.

<sup>59</sup> *Id.* at 317 (stating liability rule approved by lower court).

Judge Learned Hand held that such a price squeeze could amount to unreasonably exclusionary conduct.<sup>60</sup>

In *Pacific Bell Telephone Co. v. linkLine Communications, Inc.*,<sup>61</sup> the Roberts Court disagreed. It held that there can be no liability based on a mere price squeeze when (1) the defendant does not have an independent antitrust duty to deal with upstream rivals seeking to buy its input and (2) the price of the defendant's output remains above-cost.<sup>62</sup> In reaching that conclusion, the Court relied on two precedents, both of which reflect concerns about error and decision costs.

The first of those precedents was the Court's 2004 *Trinko* decision, which declined to impose on upstream monopolists a general duty to deal with their downstream rivals (for example, a monopolist producer of aluminum ingots who also sells fabricated aluminum products has no general antitrust duty to sell ingot to rival producers of fabricated aluminum products).<sup>63</sup> In so holding, the *Trinko* Court invoked concerns about error costs and decision costs. With respect to the former, it observed that a broad rule requiring monopolists to deal upstream with their downstream rivals could generate numerous and costly errors by encouraging collusion and reducing downstream firms' incentives to innovate.<sup>64</sup> A broad forced-sharing rule would also entail high decision costs, for "[e]nforced sharing ... requires antitrust courts to act as central planners, identifying the proper price, quantity, and other terms of dealing—a role for which they are ill suited."<sup>65</sup> Because the sum of error costs and decision costs would be higher under a general rule requiring vertically integrated monopolists to deal in the upstream market with their downstream rivals, the *Trinko* Court wisely rejected such a rule.

The other precedent on which *linkLine* was based was *Brooke Group*, which also reflects limits of antitrust thinking. As observed above, *Brooke Group*'s holding that there can be no predatory pricing liability absent below-cost

<sup>60</sup> *United States v. Aluminum Co. of America*, 148 F.2d 416, 436–37 (2d Cir. 1945) (Hand, J.). The defendant in the case, Alcoa, was the monopoly producer of aluminum ingot and also sold rolled (sheet) aluminum in a competitive market. The government alleged that Alcoa had raised the price of ingot without increasing its price for sheet aluminum, thereby squeezing the profits of other aluminum sheet producers, who had to buy their ingot from Alcoa at inflated prices but could not raise their sheet price because of competition from Alcoa. *Id.* at 437 ("The plaintiff's theory is that 'Alcoa' consistently sold ingot at so high a price that the 'sheet rollers,' who were forced to buy from it, could not pay the expenses of 'rolling' the 'sheet' and make a living profit out of the price at which 'Alcoa' itself sold 'sheet.'").

<sup>61</sup> 555 U.S. 438 (2009).

<sup>62</sup> *Id.* at 457.

<sup>63</sup> *Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko*, 540 U.S. 398, 408–11 (2004).

<sup>64</sup> *Id.* at 407–08 ("Compelling such firms to share the source of their advantage is in some tension with the underlying purpose of the antitrust law, since it may lessen the incentive for the monopolist, the rival, or both to invest in those economically beneficial facilities. ... Moreover, compelling negotiation between competitors may facilitate the supreme evil of antitrust: collusion.").

<sup>65</sup> *Id.* at 408.



pricing and a likelihood of recoupment was premised not on a belief that low but above-cost prices can never be anticompetitive but instead on skepticism about the judiciary's ability to regulate such prices without chilling procompetitive price competition.<sup>66</sup> That is ultimately a concern about error costs. In addition, the *Brooke Group* test constrains decision costs, for inquiries into whether a defendant's prices are below its costs and whether recoupment would be likely within the market at issue, though complicated, are likely to be less costly than an inquiry into whether the defendant has attempted to preclude entry by pricing below its profit-maximizing level, which is extremely difficult to ascertain.<sup>67</sup>

At the end of the day, the *linkLine* Court reasoned that a plaintiff complaining of neither a violation of some particular duty to deal with rivals (there is no general antitrust duty to do so) nor predatory pricing cannot succeed by claiming that the defendant simultaneously sold to the plaintiff (with which it had no duty to deal at all) at too high a price and to downstream purchasers at too low a price. As Chief Justice Roberts explained,

Plaintiffs' price-squeeze claim ... is ... nothing more than an amalgamation of a meritless claim at the retail level and a meritless claim at the wholesale level. If there is no duty to deal at the wholesale level and no predatory pricing at the retail level, then a firm is certainly not required to price *both* of these services in a manner that preserves its rivals' margins.<sup>68</sup>

Because each of the decisions precluding liability on the two parts of a price squeeze plaintiff's claim—*Trinko* and *Brooke Group*—was crafted to reduce the sum of error and decision costs, so was *linkLine* itself.

## C. Enforcement

The Roberts Court has decided four antitrust cases focusing not on substantive standards of liability for specific business practices but on antitrust enforcement generally. Each of the cases, *Bell Atlantic Co. v. Twombly*,<sup>69</sup> *Credit Suisse Securities (USA) LLC v. Billing*,<sup>70</sup> *FTC v. Phoebe Putney*,<sup>71</sup> and *North Carolina Dental v. FTC*,<sup>72</sup> is consistent with an effort to minimize the sum of error costs and decision costs.

### 1. *Twombly*

*Twombly*, which required so-called "plausibility" pleading in antitrust conspiracy claims, is to many observers one of the Roberts Court's most notorious

<sup>66</sup> See *supra* notes 54–55 and the accompanying text.

<sup>67</sup> See Hovenkamp, *supra* note 54, at 162–64 (discussing difficulty of policing "limit" pricing).

<sup>68</sup> Pac. Bell Telephone Co. v. *linkLine Commc'ns, Inc.*, 555 U.S. 438, 452 (2009).

<sup>69</sup> 550 U.S. 544 (2007).

<sup>70</sup> 551 U.S. 264 (2007).

<sup>71</sup> 133 S. Ct. 1003 (2013).

<sup>72</sup> 135 S. Ct. 1101, 2015 WL 773331 (Feb. 25, 2015).

decisions. Its infamy likely stems from two factors. First, it deals with pleading standards, an issue in every lawsuit. In addition, the Supreme Court later upped the ante by extending *Twombly*'s plausibility standard beyond the antitrust conspiracy context.<sup>73</sup> Putting aside *Twombly*'s later extension and focusing solely on its implications for antitrust lawsuits, however, the decision represents a sensible effort to minimize the sum of antitrust's error costs and decision costs.

At issue in *Twombly* was whether a plaintiff adequately pleads a "contract, combination ..., or conspiracy" for purposes of a section 1 action merely by alleging parallel conduct and baldly asserting that participants must have conspired to act the same way. The plaintiffs conceded that mere parallel conduct plus an allegation of conspiracy would not enable them to survive a defendant's motion for summary judgment; to survive a motion for summary judgment, they would need to prove facts tending to exclude non-collusive explanations for the alleged conspirators' parallel conduct.<sup>74</sup> Plaintiffs maintained, though, that they were not required to set forth such facts *at the pleading stage*.<sup>75</sup> The Supreme Court disagreed. It held that a section 1 complaint should be dismissed for failure to allege the agreement element ("contract, combination ..., or conspiracy") if all it alleges is parallel conduct coupled with a bald assertion of conspiracy.<sup>76</sup> To survive a motion to dismiss, a section 1 plaintiff must make non-conclusory allegations "plausibly suggesting (not merely consistent with) agreement,"<sup>77</sup> which implies that a plaintiff seeking to plead agreement with allegations of parallel conduct must, at a minimum, allege "plus factors" suggesting that the parallelism is more likely the product of agreement than of independent action.

The error costs and decision costs that would have resulted from a precedent allowing the *Twombly* plaintiffs' claim (and thus others like it) to proceed to discovery would have been quite large. As plaintiffs' lawyers know, discovery in antitrust cases can be extremely costly for defendants and, when coupled with just a slight chance that treble damages will be imposed, may induce settlement of even non-meritorious actions. Had the *Twombly* Court allowed a mere allegation of parallel conduct and a bald assertion of conspiracy to comprise the agreement element of a section 1 claim, the antitrust plaintiffs' bar would have been encouraged to search out parallel business conduct (like the parallel failure of competitors to pursue some assertedly profitable business opportunity),<sup>78</sup> make a naked assertion that defendants had "conspired" to

<sup>73</sup> See *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).

<sup>74</sup> See *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 595–98 (1986).

<sup>75</sup> *Bell Atlantic Co. v. Twombly*, 550 U.S. 544, 560–61 (2007).

<sup>76</sup> *Id.* at 569–70.

<sup>77</sup> *Id.* at 557.

<sup>78</sup> Parallel failure to pursue a profitable business opportunity was one of the bases for plaintiffs' conspiracy allegation in *Twombly*. See *id.* at 551 (according to plaintiffs, agreement was "to be inferred from the ILECs' common failure 'meaningfully [to] pursu[e]' 'attractive business

engage in such conduct (or non-conduct), prepare onerous discovery requests, and hope to extract a settlement. The error costs stemming from a procedural rule encouraging such non-meritorious strike suits could be tremendous. Decision costs would also be significant under a rule that prevented unfounded antitrust conspiracy claims from being disposed of on relatively cheap motions to dismiss but instead required that the parties go through costly discovery before the defendant could terminate the lawsuit through summary judgment.

The error costs and decision costs entailed by the *Twombly* Court's holding are likely to be significantly lower than those that would have resulted had the *Twombly* plaintiffs (and thus others like them) been allowed to proceed with their claims. Any errors resulting from *Twombly* will consist of false negatives—improper dismissals of meritorious conspiracy claims. Plaintiffs can avoid dismissal under *Twombly* by alleging either (1) facts showing an actual agreement or (2) consciously parallel conduct plus facts suggesting that the parallel behavior is more likely the product of agreement than unilateral action. That means that the only antitrust conspiracy claims barred by *Twombly* are those involving no known agreement and no “plus factors” that imply a collusive explanation for parallel conduct. Pre-complaint investigation of legitimate claims should usually reveal either sufficient facts to make a non-conclusory allegation of agreement or economic factors tending to exclude the possibility that parallel conduct resulted from independent, unilateral actions. And even if a legitimate claim was dismissed under *Twombly*, plaintiffs (and others similarly situated) could continue to monitor the situation and file suit if and when they uncovered facts suggesting an actual agreement or establishing plus factors. Because cartels are fragile and generally cannot be maintained without some policing efforts, it is likely that plaintiffs monitoring genuine collusion would eventually uncover facts that, when pled, would enable meritorious conspiracy claims to proceed.

The decision costs stemming from *Twombly*'s holding are also likely to be lower than those that would otherwise have resulted. Although *Twombly* may have the effect of forcing multiple complaints and motions to dismiss, it avoids the much greater cost associated with protracted discovery and expensive summary judgment proceedings to dispose of meritless collusion claims based solely on parallel conduct and conclusory conspiracy allegations. *Twombly*'s holding is thus fully consistent with an approach seeking to minimize the sum of antitrust's error and decision costs.

## 2. *Credit Suisse*

Because antitrust is not an industry-specific body of law, its reach may overlap with regulation focused on specific industries or behaviors. In such contexts,

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opportun[ies]’ in contiguous markets where they possessed ‘substantial competitive advantages’”) (quotations and alterations in original).

antitrust liability may be redundant, providing no added social value, or may even undermine the regulatory regime with which it overlaps. In *Credit Suisse*,<sup>79</sup> the Roberts Court confronted such an instance of regulatory overlap and had to decide whether social welfare would be enhanced by staying antitrust's hand. In concluding that a private antitrust action seeking treble damages was implicitly precluded by the federal securities laws, the Court expressly invoked concerns about error and decision costs.<sup>80</sup>

At issue in *Credit Suisse* were certain initial public offering (IPO) marketing practices that were arguably unreasonable restraints of trade among competitors (section 1 violations) but were also regulated by the federal securities laws and subject to active monitoring by the Securities and Exchange Commission (SEC). Given the implied preclusion standard set forth in prior Supreme Court precedents, the key question was whether permitting an antitrust action based on the practices would risk conflicting guidance, requirements, or standards for regulatees.<sup>81</sup> The plaintiffs maintained that no such conflict could result because the SEC had already disapproved of the complained-of activities and would likely continue to do so into the foreseeable future.<sup>82</sup> In rejecting that reasoning and concluding that maintenance of the antitrust action would be incompatible with the securities laws, the Court made little effort to identify specific points of conflict between the securities and antitrust laws. Instead, it compared the expected error costs of permitting the type of action at issue to the expected error costs of deeming such actions to be impliedly precluded.<sup>83</sup>

Even assuming that the SEC would continue to disapprove of the practices at issue, the Court reasoned, antitrust actions based on those practices would likely generate false condemnations (Type I errors). Identifying several factors that make it difficult to separate legal from illegal behavior in this context,<sup>84</sup> the Court explained:

<sup>79</sup> *Credit Suisse Secs. (USA) LLC v. Billing*, 551 U.S. 264 (2007).

<sup>80</sup> *Id.* at 278–85.

<sup>81</sup> As the Court explained, its prior precedents on securities law preemption of antitrust had established that an antitrust action is implicitly precluded when it is “clearly incompatible” with the securities laws. *Id.* at 271–75 (summarizing precedents). Four factors are relevant in determining whether such incompatibility exists: (1) whether the challenged practice lies squarely within an area of financial market activity that the securities laws seek to regulate; (2) whether an administrative body has legal authority to supervise the practice; (3) whether the regulator has, in fact, exercised its regulatory authority; and (4) whether permitting the antitrust action would risk conflicting guidance, requirements, or standards. *Id.* at 275. With respect to the complaint before the Court, no one could “reasonably dispute” that the first three factors favored preclusion; accordingly, the primary question before the Court was whether the plaintiff's complaint threatened to create a conflict between antitrust and securities law. *Id.*

<sup>82</sup> *Id.* at 278.

<sup>83</sup> *Id.* at 279–84.

<sup>84</sup> The Court identified four factors that, taken together, “make mistakes unusually likely” in this context. *Id.* at 281. The factors are: (1) the fine distinctions between permissible and impermissible conduct in the securities marketing context, *id.* at 279 (“[O]nly a fine, complex, detailed line separates activity that the SEC permits or encourages (for which respondents must

Together these factors mean there is no practical way to confine antitrust suits so that they challenge only activity of the kind the investors seek to target, activity that is presently unlawful and will likely remain unlawful under the securities law. Rather, these factors suggest that antitrust courts are likely to make unusually serious mistakes in this respect. And the threat of antitrust mistakes, *i.e.*, results that stray outside the narrow bounds that plaintiffs seek to set, means that underwriters must act in ways that will avoid not simply conduct that the securities law forbids (and will likely continue to forbid), but also a wide range of conduct that the securities law permits or encourages (but which they fear could lead to an antitrust lawsuit and the risk of treble damages).<sup>85</sup>

The Court then turned to consider the magnitude of social loss from the likely errors. It concluded that false condemnations would create significant social costs in the context at hand, for “the role that joint conduct plays in respect to the marketing of IPOs, along with the important role IPOs themselves play in relation to the effective functioning of capital markets means that the securities-related costs of mistakes is unusually high.”<sup>86</sup>

Having determined that permitting plaintiff’s antitrust action would create significant Type I error costs (a high probability of false convictions times a large magnitude of loss from such convictions), the Court compared those expected costs to the Type II error costs likely to result if the Court deemed the action to be impliedly preempted. The costs associated with such errors, the Court concluded, would likely be relatively small. First, if the conduct was already forbidden by the SEC, as the plaintiffs assumed, securities lawsuits could stop the offensive practices.<sup>87</sup> Moreover, because the securities laws already require the SEC “to take account of competitive considerations when it creates securities-related policy and embodies it in rules and regulations,”

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concede antitrust immunity) from activity that the SEC must (and inevitably will) forbid (and which, on respondents’ theory, should be open to antitrust attack.”); (2) the need for securities-related expertise, which generalist courts lack, to draw these distinctions and to determine whether, in fact, the SEC’s disapproval of a complained of practice is likely to remain permanent, *id.* at 280–81 (“[T]o distinguish what is forbidden from what is allowed requires an understanding of just when, in relation to services provided, a commission is ‘excessive,’ indeed, so ‘excessive’ that it will remain *permanently* forbidden. And who but the SEC itself could do so with confidence?”) (internal citation omitted); (3) the fact that the evidence presented in antitrust lawsuits arising from securities marketing practices would likely permit contradictory, but mutually reasonable, inferences, *id.* at 281 (“[E]vidence tending to show unlawful antitrust activity and evidence tending to show lawful securities marketing activity may overlap, or prove identical.”); and (4) the high risk of inconsistent court results as antitrust plaintiffs “bring lawsuits throughout the Nation in dozens of different courts with different nonexpert judges and different nonexpert juries,” *id.*

<sup>85</sup> *Id.* at 282; *see also id.* (“This kind of problem exists to some degree in respect of other antitrust lawsuits. But here the factors we have mentioned make mistakes unusually likely (a matter relevant to Congress’ determination of which institution should regulate a particular set of market activities).”).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at 283 (“For one thing, the SEC actively enforces the rules and regulations that forbid the conduct in question. For another, ... investors harmed by underwriters’ unlawful practices may bring lawsuits and obtain damages under the securities law.”).

there is less need for antitrust to intervene to thwart anticompetitive practices.<sup>88</sup> Accordingly, antitrust liability in this context adds little social value, and social losses from reining in its reach so much that it fails to capture some anticompetitive conduct would be relatively low.

It was thus an explicit analysis of error costs—comparing the costs of too much versus too little antitrust intervention—that led the *Credit Suisse* Court to conclude that there was an inevitable conflict between the sort of antitrust action at issue and the effective implementation of the securities laws. Although the Court did not expressly analyze likely decision costs, consideration of such costs would only have bolstered its conclusion, for a legal regime permitting plaintiffs to choose between two types of lawsuits (involving very different substantive doctrine, procedural rules, and damages formulae) in challenging a single set of business practices would almost certainly involve higher decision costs than a regime that dealt with such practices under a single body of law. The reasoning of *Credit Suisse* thus adheres to Easterbrook’s directive to minimize the sum of error and decision costs in antitrust adjudication.

### 3. *Phoebe Putney*

*Phoebe Putney* involved the scope of state action immunity—that is, the degree to which entities acting pursuant to state authority will be exempt from antitrust liability. The Supreme Court has long recognized that states should have freedom to pursue public policies without fear that their efforts will run afoul of the federal antitrust laws. For that reason, the Sherman Act does not bar states from imposing market restraints “as an act of government.”<sup>89</sup> When a substate entity (for example, a local governmental unit) is acting under state authority, its actions will be immune from federal antitrust law only if they are undertaken pursuant to a “clearly articulated and affirmatively expressed” state policy to displace competition.<sup>90</sup> That does not mean, though, that a state legislature must “expressly state in a statute or its legislative history that the legislature intends for the delegated action to have anticompetitive effects”; instead, the “clear articulation” test will be satisfied as long as the anticompetitive effect was the “foreseeable result” of what the state authorized.<sup>91</sup>

The central issue in *Phoebe Putney* was whether a competition-reducing merger that would otherwise violate the antitrust laws was a “foreseeable result” of a state’s granting of general corporate powers—including the power to buy and sell competing businesses (hospitals, in this case)—to a substate entity. The Court of Appeals had held that it was, because the state legislature could have foreseen that a local government entity with express power to acquire hospitals

<sup>88</sup> *Id.*

<sup>89</sup> *Parker v. Brown*, 317 U.S. 341, 350, 352 (1943).

<sup>90</sup> *Community Commc’ns Co. v. Boulder*, 455 U.S. 40, 52 (1982).

<sup>91</sup> *Hallie v. Eau Claire*, 471 U.S. 34, 42–43 (1985).

might engage in competition-reducing acquisitions.<sup>92</sup> Accordingly, the Court of Appeals concluded, a hospital combination orchestrated by the local hospital authority was immune from antitrust scrutiny.<sup>93</sup>

The Supreme Court disagreed. In a unanimous opinion, the Court ruled that the lower court had “applied the concept of ‘foreseeability’ from [the] clear-articulation test too loosely.”<sup>94</sup> It is not enough, the Court reasoned, for the state simply to grant general corporate powers, even acquisition authority. The Court explained, “When a State grants some entity general power to act, whether it is a private corporation or a public entity like the [local hospital] Authority, it does so against the backdrop of federal antitrust law.”<sup>95</sup> Thus, the state implicitly assumes that the delegated power will be exercised consistently with the federal antitrust laws *unless* the power being delegated—like a zoning power that cannot be exercised without restraining trade and dividing markets—is inherently inconsistent with free competition. The upshot of this ruling is that state action immunity for substate entities will exist only if the legislature expressly contemplated a displacement of competition or “the displacement of competition was the inherent, logical, or ordinary result of the exercise of the authority delegated by the state legislature.”<sup>96</sup>

This holding is consistent with an approach aimed at minimizing antitrust’s error and decision costs. Allowing a state’s granting of general corporate powers to immunize a substate entity from antitrust liability simply because the granted power *could* be exercised in an anticompetitive fashion would generate a significant number of false acquittals and thus a great deal of Type II error (that is, market power from failure to condemn truly anticompetitive practices). The Court’s holding avoids those error costs without significantly increasing the likelihood of false convictions. After all, any state legislature seeking to stay antitrust’s hand in order to pursue other laudable policies could simply express its desire to displace competition with the legislation delegating authority to the substate entity. Such intentional displacement of competition is likely to be uncommon, but it can be easily accomplished when desired. *Phoebe Putney* thus reduces total error costs by substantially decreasing the incidence of Type II errors without significantly increasing the likelihood of Type I errors.

#### 4. *North Carolina Dental*

The Court’s most recent antitrust decision also addressed state action immunity. In *North Carolina Dental*,<sup>97</sup> the Court considered the extent of a state’s

<sup>92</sup> Fed. Trade Comm’n v. Phoebe Putney Health Sys., Inc., 663 F.3d 1369, 1377 (11th Cir. 2011).

<sup>93</sup> *Id.* at 1378.

<sup>94</sup> Fed. Trade Comm’n v. Phoebe Putney, 133 S. Ct. 1003, 1012 (2013).

<sup>95</sup> *Id.* at 1013.

<sup>96</sup> *Id.* at 1012–13.

<sup>97</sup> N.C. State Bd. of Dental Examiners v. FTC, 135 S. Ct. 1101, 2015 WL 773331 (Feb. 25, 2015).

duty to “actively supervise” anticompetitive conduct fostered by state regulatory bodies. A six-Justice majority (per Justice Kennedy) held that a state regulatory board that is controlled by market participants in the industry being regulated cannot invoke “state action” antitrust immunity unless it is “actively supervised” by the state.<sup>98</sup> In so ruling, the Court struck a significant blow against protectionist rent-seeking and for economic liberty. It also reduced antitrust’s error costs by making it more difficult for competitors to collude under the guise of state action.

A North Carolina law subjects the licensing of dentistry to a state Board of Dental Examiners (Board), six of whose eight members must be licensed dentists. After dentists complained to the Board that non-dentists were charging lower prices than dentists for teeth whitening, the Board sent a cease-and-desist letter to non-dentist teeth whitening providers, warning that the unlicensed practice of dentistry is a crime. This led non-dentists to cease teeth whitening services in North Carolina. The FTC concluded that the Board’s actions violated section 5 of the FTC Act,<sup>99</sup> which prohibits unfair methods of competition (including actions that would violate sections 1 or 2 of the Sherman Act).<sup>100</sup> The Fourth Circuit agreed.<sup>101</sup>

Affirming the Court of Appeals, the Supreme Court rejected the claim that state action immunity applied to the Board’s actions.<sup>102</sup> The Court stressed that, where a state delegates control over a market to a non-sovereign actor, immunity applies only if the state accepts political accountability by actively supervising that actor’s decisions.<sup>103</sup> The Court applied its *Midcal* test, which permits immunity to attach only if the challenged anticompetitive conduct is (1) clearly articulated and affirmatively expressed as policy and (2) actively supervised by the state.<sup>104</sup> The Court then held that entities designated as state agencies are not exempt from active supervision when they are controlled by market participants, because allowing an exemption in such circumstances would pose the risk of self-dealing that the second prong of *Midcal* was created to address.<sup>105</sup>

<sup>98</sup> *Id.* at 1110.

<sup>99</sup> *In re N.C. Bd. of Dental Examiners*, 152 F.T.C. 640, 2011 WL 11798463 (Dec. 2, 2011).

<sup>100</sup> 15 U.S.C. § 45(a)(1) (“unfair methods of competition in or affecting commerce . . . are hereby declared unlawful”). The Supreme Court has held that section 5’s prohibition on unfair methods of competition extends beyond that of the Sherman Act. *See* Fed. Trade Comm’n v. Sperry & Hutchinson Co., 405 U.S. 233, 239 (1972). Nevertheless, in its *North Carolina Dental* holding, the FTC stated that it “follow[ed] the standards of [Sherman Act] Section 1 to assess whether the challenged actions of the Board violate[d] Section 5.” Memorandum Opinion and Order, *In the Matter of the North Carolina Board of Dental Examiners*, Dkt. No. 9343, at 10 (2011), <https://www.ftc.gov/sites/default/files/documents/cases/2011/12/111207ncdentalopinion.pdf>.

<sup>101</sup> N.C. Bd. of Dental Examiners v. Fed. Trade Comm’n, 717 F.3d 359 (4th Cir. 2013).

<sup>102</sup> *North Carolina Dental*, 135 S. Ct. at 1110.

<sup>103</sup> *Id.* at 1111.

<sup>104</sup> *See* Cal. Retail Liquor Dealers Ass’n v. Midcal Aluminum Inc., 445 U.S. 97 (1980).

<sup>105</sup> *Id.* at 1114.



The Board's claim that its members were "invested ... with the power of the [s]tate" was unavailing.<sup>106</sup> The Court reasoned that any exercise of sovereign power entitled to state action immunity "requires more than a mere façade of state involvement, for it is necessary ... to ensure the [s]tates accept political accountability for anticompetitive conduct they permit and control."<sup>107</sup> Here, such accountability was lacking. The Board did not contend that the state engaged in any—let alone any *active*—supervision of the Board's activities affecting competition.<sup>108</sup> The Court closed by summarizing "a few constant requirements of active supervision," namely, (1) the supervisor must review the substance of the anticompetitive decision, (2) the supervisor must have the power to veto or modify particular decisions for consistency with state policy, (3) "the mere potential for state supervision is not an adequate substitute for a decision by the State," and (4) "the state supervisor may not itself be an active market participant."<sup>109</sup> The Court cautioned, however, that "the adequacy of supervision otherwise will depend on all the circumstances of a case."<sup>110</sup>

Like *Phoebe Putney*, the Court's holding in *North Carolina Dental* helpfully limits the scope of the Court's *Parker v. Brown* decision (which shielded from federal antitrust attack a California raisin producers' cartel overseen by a state board),<sup>111</sup> without excessively interfering in sovereign state prerogatives. State legislatures may still choose to create self-interested professional regulatory bodies—their sovereignty is not compromised. Now, however, they will need to (1) make it clearer upfront that they intend to allow those bodies to displace competition, and (2) subject those bodies to disinterested third party review. Such changes undoubtedly will entail some relatively modest administrative costs, given the sort of guidance the Court has provided. Nevertheless, the administrative costs are likely dwarfed by the benefits flowing from the new regulatory transparency. That transparency should make it far easier for competition advocates (including competition agencies) to spot and publicize welfare-inimical regulatory schemes, and weaken the incentive and ability of rent-seekers to undermine competition through state regulatory processes. Such harmful schemes—particularly excessive occupational licensing restraints—are legion, and they impose enormous costs on the economy and price many consumers out of the market.<sup>112</sup> When they are put into place, there is very little doubt that they restrain competition. All told, any burdens the new judicially-imposed constraints will impose on regulating states should be far outweighed by the substantial welfare benefits such constraints are likely to generate.

<sup>106</sup> *Id.* at 1110.

<sup>107</sup> *Id.* at 1111.

<sup>108</sup> *Id.* at 1116.

<sup>109</sup> *Id.* at 1116–17.

<sup>110</sup> *Id.* at 1117.

<sup>111</sup> *Parker v. Brown*, 317 U.S. 341 (1943).

<sup>112</sup> See Aaron Edlin & Rebecca Haw, *Cartels by Another Name: Should Licensed Occupations Face Antitrust Scrutiny?*, 162 U. PA. L. REV. 1093, 1111–1116 (2014).

*North Carolina Dental* thus squarely aligns with a “limits of antitrust” approach to state action. Implementation of the decision’s guidance will entail minimal Type I error (false convictions) while substantially reducing Type II error (the prior failure to prosecute blatantly anticompetitive regulatory board decisions because of doctrinal uncertainty), yielding large net gains in consumer welfare. In particular, the absence of oversight by *disinterested* governmental appointees will become a quick screen that allows potential antitrust prosecutions to proceed. Although some decision costs may be generated in deciding whether particular new state rules pass active supervision muster, those costs would appear minor compared to the benefits from reducing Type II errors.

## D. Summation

As of this writing, each of the Roberts Court’s antitrust decisions addressing vertical restraints, exclusionary conduct, and antitrust enforcement is consistent with Easterbrook’s overarching policy prescription. We turn now to consider the degree to which the federal antitrust enforcement agencies have followed the Supreme Court’s lead and embraced a limits of antitrust approach.

## IV. THE ENFORCEMENT AGENCIES’ INSENSITIVITY TO ANTITRUST’S LIMITS

Compared to the Roberts Court, the FTC and the Antitrust Division of the U.S. Department of Justice (DOJ)—at least in recent years—have displayed far less concern for antitrust’s inherent limits. We consider here four areas in which the agencies seem to have departed from Easterbrook’s sensible approach: exclusionary conduct, vertical restraints, intellectual property rights, and merger policy.

### A. Exclusionary Conduct

The agencies’ insensitivity to the limits of antitrust is perhaps most evident in their rejection of enforcement guidelines on challenges to unilateral exclusionary conduct. As explained above, the monopolization and attempted monopolization prohibitions in section 2 of the Sherman Act are remarkably vague.<sup>113</sup> The Supreme Court has held that each violation requires some degree of market power and some instance of unreasonably exclusionary conduct,<sup>114</sup> but the line separating such conduct from vigorous but acceptable competition is blurry indeed. Accordingly, the FTC and DOJ’s Antitrust Division set out in

<sup>113</sup> See *supra* text following note 14. See generally Einer Elhauge, *Defining Better Monopolization Standards*, 56 STAN. L. REV. 253, 255 (2003) (observing that existing judicial definitions of exclusionary conduct are “not just vague but vacuous”).

<sup>114</sup> See HERBERT HOVENKAMP, *FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE* 292 (4th ed. 2011).

2006 to provide some guidance to the legal and business community about how the agencies would enforce section 2's unilateral conduct provisions.<sup>115</sup>

In formulating the Section 2 Report, the FTC and DOJ held an extensive, year-long series of joint hearings consisting of 29 panels featuring 119 witnesses.<sup>116</sup> Some of the hearings considered broad issues, such as how to measure market power and fashion antitrust remedies. Most, however, were focused on particular business practices that have sometimes been held to violate section 2. Participants in the hearings set forth the theoretical anticompetitive harms and procompetitive benefits of the practices under consideration, summarized the existing empirical evidence on the incidence of various competitive effects, and made recommendations about which substantive liability standards would maximize the net benefits of antitrust intervention. The final Section 2 Report, released in September 2008 and consisting of more than 200 pages, set forth principles to guide agency enforcement decisions in cases involving predatory pricing and bidding,<sup>117</sup> exclusive dealing,<sup>118</sup> tying,<sup>119</sup> single-product and bundled loyalty discounts,<sup>120</sup> and unilateral refusals to deal.<sup>121</sup> The Report also addressed potentially exclusionary conduct not falling into one of the aforementioned categories and thus not subject to a conduct-specific liability test.<sup>122</sup> Such conduct, the Report concluded, should be deemed unlawful under section 2 only if its anticompetitive effects were shown to be substantially disproportionate to any associated procompetitive effects.<sup>123</sup>

The Section 2 Report was very much attuned to the limits of antitrust. For each of the particular practices addressed, the Report assessed why it is a competitive mixed bag—that is, how it could occasion anticompetitive harm but might also create procompetitive benefits. The Report then set forth liability rules designed to be both administrable and capable of condemning most anticompetitive instances of a practice while screening out those that are likely to create net benefits. Evident throughout the Report—perhaps most notably

<sup>115</sup> Press Release, Fed. Trade Comm'n, FTC and DOJ to Host Joint Public Hearings on Single-Firm Conduct as Related to Competition (Nov. 28, 2005), <http://www.ftc.gov/news-events/press-releases/2005/11/ftc-and-doj-host-joint-public-hearings-single-firm-conduct>. Section 2 also prohibits some concerted conduct, conspiracy to monopolize. 15 U.S.C. § 2. The agencies' guidelines project did not address such conduct and instead focused only on unilateral (single-firm) offenses.

<sup>116</sup> See U.S. DEPARTMENT OF JUSTICE, COMPETITION AND MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT 1 (2008) [hereinafter *Single-Firm Conduct Report*]. Four of the panels were held outside Washington, D.C. (in Chicago and Berkeley, California) and involved witnesses from the business community. *Id.*

<sup>117</sup> *Id.* at 49–76.

<sup>118</sup> *Id.* at 131–42.

<sup>119</sup> *Id.* at 77–90.

<sup>120</sup> *Id.* at 91–118.

<sup>121</sup> *Id.* at 119–30.

<sup>122</sup> *Id.* at 33–46.

<sup>123</sup> *Id.* at 45–46.

in the requirement that conduct not falling into one of the specific categories “disproportionately” impair consumer welfare before being condemned—were concerns about over-detering output-enhancing behavior and a belief that market power is self-destructive (such that over-deterrence, or Type I error, is of greater concern than under-deterrence, or Type II error). Thus, the Report, like Easterbrook’s famous article, acknowledged the inevitability of errors in section 2 enforcement and adjudication, highlighted the need to minimize error costs, emphasized administrable rules and screening devices, and recognized that over-deterrence is generally more harmful than under-deterrence in the antitrust context.

In the end, the enforcement agencies abandoned the Section 2 guidelines. The FTC never even signed on to the final Report.<sup>124</sup> According to a majority of the Commissioners, the Report was deficient *because it endorsed a limits of antitrust approach*. The majority downplayed the risk of error,<sup>125</sup> rejected the view that over-deterrence is of greater concern in this context than under-deterrence,<sup>126</sup> questioned the degree to which market power tends to be self-correcting,<sup>127</sup> and discounted the value of administrable rules and screening devices.<sup>128</sup> In short, the Commission eschewed an enforcement policy premised on Easterbrook’s ideas. The September 2008 Report thus reflected the enforcement policies of only the DOJ.

Even that effect was short-lived. In May 2009, Assistant Attorney General Christine Varney, delivering her first public remarks after President Obama appointed her as the head of the DOJ’s Antitrust Division, announced that the

<sup>124</sup> See FEDERAL TRADE COMMISSION, STATEMENT OF COMMISSIONERS HARBOUR, LEIBOWITZ, AND ROSCH ON THE ISSUANCE OF THE SECTION 2 REPORT BY THE DEPARTMENT OF JUSTICE 1 (Sept. 2008) (“The Federal Trade Commission (‘FTC’) does not endorse the Department’s Report.”).

<sup>125</sup> *Id.* at 3 (“The Report notes that it is often difficult to distinguish between aggressive competition and exclusionary conduct. . . . We believe that the federal antitrust enforcement agencies and the private antitrust bar are (and will remain) up to that task, in the section 2 realm and elsewhere.”).

<sup>126</sup> *Id.* at 3–4 (observing that “the Report downplays the risk of under-enforcement” and asserting that the view that over-deterrence is of greater concern than under-deterrence “does not adequately consider the harm consumers will suffer while waiting for the correction to occur”).

<sup>127</sup> *Id.* at 4 (“Markets can and do take years, even decades, to correct themselves. For one reason or another, it may take a long time for rivals to surmount entry barriers or other impediments to effective competition.”).

<sup>128</sup> See *id.* (asserting that “[w]hile clear rules are desirable in the abstract, the benefits of clarity must be balanced against the benefits of effective and reasonable law enforcement, lest the interests of consumers be compromised” and contending that “the Report overstates the extent to which the Supreme Court has embraced bright-line rules of *per se* legality”); see also *id.* (“[N]o one—including the Department—has yet provided a methodology for weighing the costs and benefits of Section 2 enforcement (including potential remedies), or for comparing the relative costs and benefits to businesses versus consumers. Therefore, we do not agree that any category of conduct can be excluded from the scope of Section 2 based on the difficulty of devising an appropriate remedy.”).

DOJ would no longer adhere to the principles set forth in the Section 2 Report.<sup>129</sup> Like the FTC majority, Varney downplayed the risk of over-deterrence and expressed confidence in antitrust enforcers' ability to distinguish between good and bad instances of mixed-bag unilateral practices:

The Report sounds a call of great skepticism regarding the ability of antitrust enforcers—as well as antitrust courts—to distinguish between anticompetitive acts and lawful conduct, and raises the related concern that the failure to make proper distinctions may lead to “over-deterrence” with regard to potentially procompetitive conduct. I do not share these concerns. I strongly believe that antitrust enforcers are able to separate the wheat from the chaff in identifying exclusionary and predatory acts.<sup>130</sup>

Varney further asserted that “[t]he Report ... goes too far in evaluating the importance of preserving possible efficiencies and understates the importance of redressing exclusionary and predatory acts that result in harm to competition, distort markets, and increase barriers to entry.”<sup>131</sup> The disproportionality test, she maintained, “reflects an excessive concern with the risks of over-deterrence and a resulting preference for an overly lenient approach to enforcement.”<sup>132</sup> In expressing equal concern for the risks of over- and under-deterrence, Varney implicitly rejected Easterbrook's position.<sup>133</sup>

Both enforcement agencies, then, have refused to recognize the limits of their ability to enhance consumer welfare by pursuing unilateral business

<sup>129</sup> Christine A. Varney, Assistant Attorney General, Vigorous Antitrust Enforcement in This Challenging Era, Remarks Before the Center for American Progress (May 11, 2009), <http://www.justice.gov/atr/public/speeches/245711.pdf>.

<sup>130</sup> *Id.* at 6.

<sup>131</sup> *Id.* at 7.

<sup>132</sup> *Id.* at 8.

<sup>133</sup> See Easterbrook, *supra* note 2, at 2–3 (contending that false convictions create greater social loss than false acquittals). Varney's lack of concern about over-deterrence should have come as no surprise. Prior to her confirmation, she made public remarks suggesting that she believed over-deterrence was not a problem in the antitrust context. In a presentation in which she endorsed a number of enforcement ideas from the reliably interventionist American Antitrust Institute, Varney stated:

... I was prepared to say there is *no such thing as a false positive*; you know, let's get real. I have counseled numerous incumbents who are dominant as well as numerous new entrants. I can tell you, at least in my own experience, there is not a dominant incumbent who hasn't done something that is lawful because they were afraid that it might be reviewed by the DOJ or a state attorney general or an FTC. I just don't see it. Ten years back in the private sector I have never once seen it. So I think that this ruse of, you know, we have to be restrained in our enforcement because false positives will chill innovation, take an economic toll on society and overall result in negative economic consequence, slowing output, increasing cost, *I just think is false. I think the more people in the bars start rejecting this idea of false positives the better off we're going to be.*

See Josh Wright, *DOJ AAG Designate Christine Varney on Section 2, Europe, Google & a Puzzling Statement About Error Costs*, TRUTH ON THE MARKET (Feb. 22, 2009), <http://truthonthemarket.com/2009/02/22/doj-aag-designate-christine-varney-on-section-2-europe-google-a-puzzling-statement-about-error-costs/>.

conduct that has some tendency to exclude rivals. Given that much welfare-enhancing single-firm conduct has an incidental exclusionary effect, the agencies' hubris will likely injure consumers in the long run.<sup>134</sup>

## B. Vertical Restraints

While the Roberts Court's two vertical restraints decisions, *Leegin* and *Independent Ink*, modified antitrust doctrine in a manner that would reduce the sum of error and decision costs,<sup>135</sup> several recent agency actions in vertical restraint cases reveal an insensitivity to the limits of antitrust and are likely to enhance the error costs associated with regulation of both intrabrand and interbrand vertical restraints.

### 1. Vertical Intrabrand Restraints (RPM)

In 2000, the FTC sued women's shoe manufacturer Nine West for violating the then-prevailing *per se* rule against minimum resale price maintenance (RPM).<sup>136</sup> The lawsuit resulted in a consent order in which Nine West agreed to refrain from a number of business practices that could dissuade its dealers from offering discounts on its products.<sup>137</sup> After the *Leegin* Court abrogated the *per se* rule against minimum RPM, Nine West petitioned the FTC for a modification of the consent order.<sup>138</sup> Although the Commission ultimately agreed to modify the order, its response suggested that it intends to subject RPM to an unwarranted level of scrutiny, one that will produce significant Type I (false conviction) error costs.

The Commission stated that it would evaluate RPM under a version of the truncated analysis it adopted in *Polygram Holding, Inc. v. FTC*, which held that an "inherently suspect" restraint of trade will be presumed unreasonable

<sup>134</sup> For example, in a case discussed in more detail below (*see infra* notes 157–166 and accompanying text), the FTC accused Intel Corp. of violating section 2 by offering above-cost loyalty rebates that likely would have passed muster under the guidelines in the Section 2 Report. *See* Single-Firm Conduct Report, *supra* note 115, at 116–17 (positing liberal liability standard for above-cost loyalty rebates). As explained below, Intel settled the FTC action by entering a consent decree in which it agreed not to offer loyalty discounts—which are ultimately price cuts likely to be passed on to end-user consumers—in the future. Surely many of Intel's now-forbidden discounts would have been procompetitive. Moreover, because of the FTC action and subsequent settlement, similarly situated firms are likely to forego their own loyalty discounts; they certainly have a fair response when purchasers of their products press for such price cuts.

<sup>135</sup> *See supra* notes 26–47 and accompanying text.

<sup>136</sup> *See* Complaint, *In re* Nine West Group, Inc., F.T.C. Dkt. No. C–3937 (Apr. 11, 2000), <http://www.ftc.gov/sites/default/files/documents/cases/2000/04/ninewestcmp.htm>.

<sup>137</sup> *See* Decision and Order, *In re* Nine West Group, Inc., F.T.C. Dkt. No. C–3937 (Apr. 11, 2000), [http://www.ftc.gov/sites/default/files/documents/cases/2000/04/ninewest.do\\_.htm](http://www.ftc.gov/sites/default/files/documents/cases/2000/04/ninewest.do_.htm).

<sup>138</sup> *See* Petition to Reopen and Modify Order, *In re* Nine West Group, Inc., F.T.C. Dkt. No. C–3937 (Oct. 30, 2007), <http://www.ftc.gov/sites/default/files/documents/cases/2007/11/071106petition.pdf>.

unless the defendant “either identif[ies] some reason the restraint is unlikely to harm consumers or identif[ies] some competitive benefit that plausibly offsets the apparent or anticipated harm.”<sup>139</sup> A group of states had asked the Commission to declare all instances of RPM to be inherently suspect since the practice usually raises consumer prices.<sup>140</sup> The Commission wisely rejected that position in recognition of the fact that higher consumer prices are the very mechanism by which RPM may generate dealer services that enhance output and benefit consumers.<sup>141</sup> But it still endorsed a fairly inhospitable liability rule. Under the approach the Commission adopted, a defendant manufacturer may avoid the conclusion that its RPM is inherently suspect only if it proves: (1) that the manufacturers using RPM do not comprise a significant portion of the relevant market; (2) that the manufacturer, not its dealers, initiated the RPM; and (3) that there is no dominant manufacturer or dealer with market power.<sup>142</sup> If the defendant fails to make such a showing, its RPM will be presumed unreasonable and will be illegal unless the defendant proves that the RPM enhanced its total sales relative to what they would have been absent the pricing policy.<sup>143</sup>

This liability rule tilts heavily against defendant manufacturers, who must sustain a heavy proof burden to avoid treble damages in RPM cases. First, a defendant faces the difficult task of establishing the relevant manufacturer market<sup>144</sup> and producing data on the use of RPM by other manufacturers in that market and their market shares. The defendant then has to prove that it, not its dealers, initiated the RPM. That showing would be difficult to make if there were any evidence that high-service dealers had complained about their low-service, presumably cheaper, rivals. Such dealer complaints may simply have alerted the manufacturer of the need to induce higher dealer quality by reducing price competition,<sup>145</sup> but they could easily be taken to suggest that

<sup>139</sup> *Polygram Holding, Inc. v. FTC*, 416 F.3d 29, 36 (D.C. Cir. 2005).

<sup>140</sup> See Amended States’ Comments Urging Denial of Nine West’s Petition 8, *In re Nine West Group, Inc.*, F.T.C. Dkt. No. C–3937 (Jan. 17, 2008), [http://www.ag.ny.gov/sites/default/files/pdfs/bureaus/antitrust/Amended\\_State\\_comments\\_011708-9west.pdf](http://www.ag.ny.gov/sites/default/files/pdfs/bureaus/antitrust/Amended_State_comments_011708-9west.pdf).

<sup>141</sup> See Order Granting in Part Petition to Reopen and Modify Order Issued April 11, 2000, *In re Nine West Group, Inc.*, F.T.C. Dkt. No. C–3937, at 13 (May 6, 2008), <http://www.ftc.gov/sites/default/files/documents/cases/2008/05/080506order.pdf>.

<sup>142</sup> *Id.* at 13–15.

<sup>143</sup> *Id.* at 15–16.

<sup>144</sup> In its consideration of Nine West’s petition for modification, for example, the FTC required Nine West to expend significant effort demonstrating the contours of the market in which it participates. See Letter from Ronald S. Rolfe, Esq., Cravath, Swaine & Moore, LLP to Eric D. Rohlick, Federal Trade Commission, *In re Nine West Group, Inc.*, F.T.C. Dkt. No. C–3937 (Mar. 26, 2008), <http://www.ftc.gov/sites/default/files/documents/cases/2008/03/080326ninewestadditionalinfo.pdf>.

<sup>145</sup> See *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 762–63 (1984) (observing that manufacturers who respond to dealer complaints about price-cutting dealers may be motivated by a concern to preserve or enhance dealer services, not by a desire to assist complaining dealers).

dealers, not the manufacturer, initiated the restraint. Finally, a defendant manufacturer must establish its own lack of market power and the absence of market power on the part of each of its dealers. The latter showing requires the defendant to define a second (dealer) market. If the defendant fails to make any of these showings, it can avoid liability only by proving that its RPM increased its overall output. To do that, it must engage in sophisticated statistical analysis to isolate the effects of RPM from other factors that could affect overall output.

In short, the FTC's evaluative approach requires any manufacturer adopting an RPM policy to be prepared to make a difficult showing to avoid treble damages liability. As a consequence, the approach discourages RPM arrangements despite the fact that both theoretical considerations and empirical evidence suggest that they are more likely to enhance than to reduce overall market output.<sup>146</sup> The Commission's approach is sure to produce greater error costs than would a liability rule requiring plaintiffs in RPM cases to produce evidence of either an actual reduction in market output or the prerequisites to one of the well recognized theories of RPM-induced anticompetitive harm.

## 2. Vertical Interbrand Restraints

Exclusive dealing and loyalty discounts are related practices. In an exclusive dealing arrangement, the seller, often a manufacturer, conditions the sale of its product on an agreement by the buyer, often a retailer, to purchase all its requirements from that seller.<sup>147</sup> With loyalty discounts, the seller does not *require* exclusivity or near exclusivity but instead gives a discount (or rebate) on all the buyer's purchases of a product if the buyer purchases from the seller some predetermined amount, often a percentage of the buyer's requirements.<sup>148</sup> Exclusive dealing and loyalty discounts are vertical interbrand restraints because they have the effect of restraining the downstream party, the buyer, from trading in brands competing with those of the upstream party, the seller.

Both practices may occasion anticompetitive harms or procompetitive benefits. On the harm side, contracts that mandate or encourage exclusivity may reduce overall market output if they have the effect of foreclosing a producer's rivals from so many sales opportunities that the rivals are forced to reduce their output below minimum efficient scale.<sup>149</sup> A dominant firm that prevents its rivals from attaining economies of scale and thereby raises their per-unit costs

<sup>146</sup> See *supra* notes 30–34 and accompanying text.

<sup>147</sup> See Single-Firm Conduct Report, *supra* note 115, at 131. When a restaurant franchisee agrees to buy all its ingredients from a franchisor, for example, the parties have engaged in exclusive dealing.

<sup>148</sup> *Id.* at 106. For example, a producer of surgical sutures might give a 20 percent discount on all sutures sold to a particular hospital if the hospital buys at least 70 percent of its sutures from the producer.

<sup>149</sup> See Joshua D. Wright, *Moving Beyond Naïve Foreclosure Analysis*, 19 GEO. MASON L. REV. 1163, 1166–67 (2012).



will be less constrained by price competition and may be able to charge more for its products. For such anticompetitive harm to result, though, at least three circumstances must exist. First, the degree of foreclosure caused by the perpetrator's exclusive dealing must be substantial enough to drive (or hold) at least some rivals below minimum efficient scale;<sup>150</sup> foreclosing, say, one percent of sales opportunities likely would not raise rivals' costs. Second, it must be impracticable for foreclosed rivals to bypass the buyers subject to the exclusive dealing arrangements and sell to others by, for example, integrating forward into distribution or selling through newly entering distributors. Finally, output-reducing exclusive dealing is unlikely absent significant barriers to entry in the producer market. If market power created by foreclosure-inducing exclusive dealing could be easily undermined by new firms entering the producer market in response to supracompetitive prices, producers—who generally have to “pay” something to induce exclusivity—would be unlikely to attempt monopolization via exclusive dealing, and even if they did so, consumer harm would be unlikely.

On the benefit side, vertical arrangements mandating or encouraging exclusivity may (1) encourage producers to invest in downstream buyers' (for example, retailers') operations by preventing “interbrand free-riding” by competing producers,<sup>151</sup> (2) reduce consumer prices by intensifying competition among producers for distribution,<sup>152</sup> (3) enhance consumer welfare by reducing the costs associated with uncertain supply and demand,<sup>153</sup> and (4)

<sup>150</sup> *Id.* at 1166 (“A consensus has emerged that a necessary condition for anticompetitive harm arising from allegedly exclusionary agreements is that the contracts foreclose rivals from a share of distribution sufficient to achieve [MES].”).

<sup>151</sup> A manufacturer of gasoline, for example, may try to increase its sales by providing the independent retailers that carry its brand with attractive signage, good lighting, and free items for customers (for example, roadmaps). If such a retailer were also to carry gasoline produced by another manufacturer that did not provide similar retailer investments (and thus bore less cost, permitting it to charge lower wholesale prices), many of the additional sales resulting from the amenities provided by the investing producer would flow to its non-investing, lower-cost rival. By assuring investing producers that their retailer investments will not inure to the benefit of their rivals, exclusive dealing may encourage producers to make consumer-friendly, output-enhancing investments in the distributors that carry their brands. *See generally* Howard P. Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1, 6–11 (1982).

<sup>152</sup> To induce retailer exclusivity and the heightened sales that it will generate, producers often lower their wholesale prices in exchange for exclusive dealing. Competition among retailers for customers thus ensures that those wholesale price-savings are passed on to consumers in the form of lower retail prices. Those lower retail prices, in turn, more than make up for any welfare loss occasioned by reduced consumer choice. By intensifying the competition for access to a retailer, exclusive dealing may therefore confer a net benefit on consumers. *See generally* Benjamin Klein & Kevin M. Murphy, *Exclusive Dealing Intensifies Competition for Distribution*, 75 ANTITRUST L.J. 433 (2008).

<sup>153</sup> Distributors may find exclusive dealing contracts to be the optimal way to assure a steady source of supply. A gasoline retailer, for example, will want to ensure adequate gasoline supplies for the busy summer months. It could contract in advance to purchase some fixed quantity of gasoline from a producer, but it would run the risk that consumer demand may either soften, leaving it with a glut of gasoline, or spike, leaving it without sufficient gasoline

encourage the production of multicomponent systems by protecting producers of complete systems from adverse “cherry picking” by producers of popular, high-margin individual components.<sup>154</sup> Given that exclusive dealing has these many procompetitive uses and is likely to cause anticompetitive harm in only a narrow set of circumstances, it should come as no surprise that empirical studies find most instances of exclusive dealing to enhance, rather than reduce, competition.<sup>155</sup>

Because exclusive dealing and related arrangements like loyalty discounts are usually procompetitive, a showing of harm to competition—an actual or likely reduction in overall market output, not simply harm to an individual competitor—should be a prerequisite to antitrust liability. Supreme Court precedent requires as much,<sup>156</sup> and some older FTC decisions have honored the

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and forcing it to find other suppliers. The retailer’s lowest-cost option for assuring an adequate, but not excessive, supply of gasoline may well be to enter a requirements contract under which it promises to buy all its requirements from a single gasoline producer in exchange for that producer’s promise to supply all that is required. On the producer side, exclusive dealing may reduce uncertainty and thereby decrease costs (and ultimately prices) by assuring producers of a steady source of demand for their output. By making it easier for producers to forecast demand for their products, exclusive dealing reduces the risk associated with, and thus encourages, investments in productive facilities. See Hovenkamp, *supra* note 18, at 439.

<sup>154</sup> Products like plumbing systems often utilize multiple parts (pipes, valves, etc.) that are similar in design, have comparable fixed costs of production, and are used together but not in fixed proportions. Consumers benefit from having ready access to full lines of such component parts. Full-line forcing, a type of exclusive dealing, may prevent adverse “cherry-picking” that discourages full-line production. See *infra* note 185 and accompanying text.

<sup>155</sup> See Jan B. Heide, Shantanu Dutta & Mark Bergen, *Exclusive Dealing and Business Efficiency: Evidence from Industry Practice*, 41 J.L. & ECON. 387, 387 (1998) (finding that “firms are more likely to use exclusive dealing when there is a potential that other manufacturers can free ride on the services they provide” and that “when manufacturers are concerned about the costs that exclusive dealing imposes on end customers, such arrangements are less likely”); Tim R. Sass, *The Competitive Effects of Exclusive Dealing: Evidence from the U.S. Beer Industry*, 23 INT’L J. INDUS. ORG. 203 (2005) (concluding that exclusive dealing in the beer market increases market output); James C. Cooper, Luke Froeb, Daniel P. O’Brien & Michael Vita, *Vertical Antitrust Policy as a Problem of Inference*, 23 INT’L J. INDUS. ORG. 639, 658 (2005) (observing that although “some studies find evidence consistent with both pro and anticompetitive effects ... virtually no studies claim to have identified instances where vertical practices were likely to have harmed competition”); Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy in* HANDBOOK OF ANTITRUST ECONOMICS 391 (Paolo Buccirossi ed., 2008) (“[I]t appears that when manufacturers choose to impose restraints, not only do they make themselves better off but they also typically allow consumers to benefit from higher quality products and better service provision.”); Daniel O’Brien, *The Antitrust Treatment of Vertical Restraints: Beyond the Possibility Theorems in* THE PROS AND CONS OF VERTICAL RESTRAINTS 40, 72–73 (2008) (observing that “with few exceptions, the literature does not support the view that [vertical restraints] are used for anticompetitive reasons”).

<sup>156</sup> See, e.g., *Tampa Elec. Co. v. Nashville Coal Co.*, 365 U.S. 320, 329 (1961) (requiring showing of harm to competition).

“harm to competition” requirement in exclusive dealing cases.<sup>157</sup> In several recent FTC actions, however, the Commission has paid only lip service to the requirement, ignoring actual market evidence suggesting an absence of competitive harm from challenged arrangements and allowing mere harm to a competitor to suffice as a basis for imposing liability.

*a. Intel*

In late 2009, the FTC sued Intel Corp., claiming that the company’s loyalty rebates on microprocessor and graphics processor units (“CPUs” and “GPUs”) violated section 2 of the Sherman Act and constituted an “unfair method of competition” in violation of section 5 of the Federal Trade Commission Act.<sup>158</sup> Intel had paid significant rebates to computer producers (original equipment manufacturers or “OEMs”) that purchased high percentages of their CPU and GPU requirements from Intel. Intel’s chief rival, Advanced Micro Devices (“AMD”), had brought and settled a complaint alleging that Intel’s loyalty rebates had the effect of foreclosing AMD from so many sales opportunities that it was driven below minimum efficient scale.<sup>159</sup> The FTC’s complaint mirrored AMD’s action and added some theories involving graphics chips. In October 2010, Intel settled the FTC action, entering a consent decree in which it agreed, among other things, not to offer any loyalty discounts or rebates on its chipsets.<sup>160</sup>

The problem with the FTC action and subsequent consent decree is that actual market evidence suggested an absence of harm to competition from Intel’s loyalty rebates, which were ultimately price cuts that OEMs, in competing with each other, passed along to consumers. Intel’s loyalty discounts began in 1999, which implied that, by the time the FTC filed its complaint, there was no need to speculate on their competitive effect. As then-Professor (now FTC Commissioner) Joshua Wright observed, the FTC’s theory that Intel’s loyalty rebates harmed competition by driving AMD below minimum efficient scale “ha[d] several testable implications.”<sup>161</sup> If the discounts indeed constituted anticompetitive harm, rather than simply vigorous competition that may have

<sup>157</sup> See, e.g., *In re Beltone Electronics*, 100 F.T.C. 68, 204 (1982).

<sup>158</sup> Complaint, *In re Intel Corp.*, F.T.C. Dkt. No. 9341 (Dec. 16, 2009), <http://www.ftc.gov/sites/default/files/documents/cases/091216intelcmpt.pdf>. As observed above, Section 5’s prohibition of unfair methods of competition extends beyond the scope of Sherman Act prohibitions. See *supra* note 99.

<sup>159</sup> See Settlement Agreement Between Advanced Micro Devices Inc. and Intel Corporation (Nov. 11, 2009), [http://download.intel.com/pressroom/legal/AMD\\_settlement\\_agreement.pdf](http://download.intel.com/pressroom/legal/AMD_settlement_agreement.pdf).

<sup>160</sup> See Decision and Order, *In re Intel Corp.*, F.T.C Dkt. No. 9341 (Oct. 29, 2010), <http://www.ftc.gov/sites/default/files/documents/cases/101102inteldo.pdf> (stating that Intel shall not, for a ten-year period, “condition[] any Benefit to a Customer based on the Market Segment Share of a Relevant Product or a Computer Product Chipset that a Customer awards to [Intel] or to any competitor”).

<sup>161</sup> Joshua D. Wright, *An Antitrust Analysis of the Federal Trade Commission’s Complaint Against Intel* 6, ICLE Antitrust and Competition Policy White Paper (June 8, 2010), [http://www.academia.edu/2821047/An\\_Antitrust\\_Analysis\\_of\\_the\\_Federal\\_Trade\\_Commission\\_s\\_Complaint\\_Against\\_Intel\\_](http://www.academia.edu/2821047/An_Antitrust_Analysis_of_the_Federal_Trade_Commission_s_Complaint_Against_Intel_).

made life harder for AMD but ultimately enhanced output, then one would expect that:

- Intel’s market share would have increased and AMD’s decreased since 1999;
- Intel’s share price would have increased and AMD’s decreased following implementation of the rebates; and
- AMD would have avoided significant investments in future capacity, given that the company would face difficulty recouping its investment expenditures once it was excluded from the marketplace.<sup>162</sup>

In fact, the evidence showed something very different. The market shares of Intel and AMD remained fairly constant from 1999 to 2009; there was no obvious reduction in AMD’s market share after Intel commenced its discounting.<sup>163</sup> Moreover, stock price data from the relevant time period appear inconsistent with the theory that Intel was anticompetitively raising AMD’s costs to earn supracompetitive profits. The stock prices of the two companies generally moved in tandem, suggesting that price variation over time was due to the two competitors’ facing similar economic circumstances.<sup>164</sup> Finally, AMD’s substantial capacity expansion and investments in research and development following implementation of Intel’s loyalty discounts suggested that AMD itself did not believe that it was being driven below minimum efficient scale. Why would it invest billions of dollars upfront absent an expectation of future returns?<sup>165</sup>

<sup>162</sup> *Id.* at 7.

<sup>163</sup> *Id.* at 7–8.

<sup>164</sup> *Id.* at 9–13. The performance of AMD’s stock did degrade relative to Intel’s after 2006, but the Commission’s theory would have predicted such degradation at an earlier time, and AMD’s stock travails were more plausibly explained by adverse business developments: in 2007, AMD suffered botched releases of its Barcelona and ATI products, as well as discovering a design flaw in its Barcelona “quad-core” product. Given that AMD’s adverse stock performance occurred just as it had gained Toshiba as a customer and was thus able to expand distribution, it seems more likely that AMD’s own product difficulties—not distribution restrictions occasioned by Intel’s discounting—were to blame for AMD’s poor post-2006 performance. *See id.* 11–12 & n.36 (citing *AMD Hit By Losses Across All Divisions*, MSN MONEYCENTRAL (Dec. 12, 2007), <http://news.moneycentral.msn.com/provider/providerarticle.aspx?feed=FT&date=20071213&id=7941190>).

<sup>165</sup> As Wright explained, “AMD’s substantial investments into research and development and expanded capacity during the relevant time frame” undermine the FTC’s theory that Intel’s loyalty rebates were anticompetitively raising AMD’s costs by foreclosing enough sales opportunities to drive it below minimum efficient scale:

For example, in October 2005, AMD announced the opening of Fab 36 in Dresden, Germany, and expected to invest a total of \$2.5 billion in this facility by November 2007. It has also been reported that AMD has made substantial investments into converting its existing Fab 30 from the 130-nm process to the 90-nm process. The evidence appears to support the view that AMD is able to sell all of the chips that it is able to produce and AMD’s capacity, not Intel’s conduct, constrained AMD. If AMD is successfully selling

Of course, the most important testable implication of the FTC's theory of anticompetitive harm was that Intel's loyalty discounts would result in market output being lower than it otherwise would have been. Again, the evidence suggested something different. In the ten years in which Intel engaged in allegedly exclusionary conduct, microprocessor prices fell at an average rate of 40 percent *annually*.<sup>166</sup> Indeed, quality-adjusted prices of computer microprocessors declined more rapidly during the relevant period than did the prices of products in all 1,200 other product categories monitored by the Bureau of Labor Statistics.<sup>167</sup>

None of this *proves*, of course, that Intel's loyalty discounts enhanced market output from what it otherwise would have been. It could well be that, absent Intel's discounts, (1) AMD's market share would have increased relative to Intel's; (2) AMD's stock performance would have exceeded, rather than mirrored, that of Intel; (3) AMD's investments in capacity expansion and research and development would have been even greater than they were; and (4) computer processor prices would have fallen even faster than they did. But in light of the fact that exclusivity-inducing vertical arrangements are usually pro-competitive—and that these particular arrangements resulted in an immediate consumer benefit, lower prices—Intel should not have borne the burden of *disproving* the Commission's theory of harm. By extracting a discount-chilling settlement from Intel based on a practice that had long been in existence and yet had produced no apparent harm to competition, the Commission likely created significant Type I error costs.

#### *b. McWane*

The FTC's recent decision in *In re McWane*<sup>168</sup> similarly condemned an exclusive dealing arrangement on the basis of a theoretical anticompetitive harm, even though the arrangement had been in place for long enough to generate an anticompetitive effect without apparently having done so. The complaint counsel claimed that defendant McWane, the dominant producer of domestic iron pipe fittings, had monopolized the market by instituting a "full support policy" under which it would sell its products only to distributors that carried

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all the chips it can produce, and capacity constraints unrelated to Intel's conduct are the binding constraint on AMD's production, such evidence would be inconsistent with the Commission's theory. Moreover, if AMD *believed* that Intel's conduct was leading inexorably to AMD's demise it would be unlikely to make such substantial up-front investments with the expectation of future returns.

Wright, *supra* note 160, at 13–14.

<sup>166</sup> *Id.* at 14.

<sup>167</sup> *Id.* (citing U.S. Bureau of Labor Statistics Producer Price Index, series identification numbers PCU33441333441312 (Microprocessors), <http://data.bls.gov/cgi-bin/dsrv?pc> (Mar. 7, 2010)).

<sup>168</sup> Opinion of the Commission, *In re McWane, Inc.*, F.T.C. Dkt. No. 9351 (Jan. 30, 2014), [http://www.ftc.gov/system/files/documents/cases/140206mcwaneopinion\\_0.pdf](http://www.ftc.gov/system/files/documents/cases/140206mcwaneopinion_0.pdf).

its fittings exclusively.<sup>169</sup> The policy was subject to two exceptions: where McWane products were not available, and where a distributor purchased a McWane rival's pipe in addition to its fittings.<sup>170</sup> The FTC concluded that the policy caused anticompetitive harm by artificially holding McWane's rivals below minimum efficient scale, thereby raising their costs and enhancing McWane's ability to raise its own prices.<sup>171</sup> It thus exercised its authority under section 5 of the FTC Act to impose liability for monopolization.<sup>172</sup>

There are many reasons to question the Commission's determination that McWane had engaged in anticompetitive exclusionary conduct. First, the evidence on what constituted minimum efficient scale in the relevant market was remarkably thin, consisting entirely of testimony by rival Star Pipe Products, Ltd. ("Star") that it would face lower average costs if it owned a foundry but could not justify building one given its low market share.<sup>173</sup> Countering that self-serving testimony were a couple of pieces of actual market evidence. First, the second-largest domestic seller of pipe fittings, Sigma Corp., somehow managed to enter the pipe fittings market and capture a 30-percent market share (as opposed to Star's 20-percent), without owning any of its own production facilities. Such success suggested that foundry ownership—and, thus, a level of sales sufficient to support foundry construction—may not be necessary for efficient scale in the domestic pipe fittings industry.<sup>174</sup> So did Star's own success. Star entered the pipe fittings market in 2009, quickly grew to a 20-percent market share, and was on pace to continue growth when the *McWane* action commenced in January 2012.<sup>175</sup> As Commissioner Wright observed, "for [the Commission's] view of MES [that is, minimum efficient scale] to make sense on the facts that exist in the record, Star would have to be operating below MES, becoming less efficient over time as McWane's Full Support Program further raised the costs of distribution, and yet remaining in the market and growing its business. Such a position strains credulity."<sup>176</sup>

In addition to failing to establish what constitutes minimum efficient scale in the pipe fittings industry, the FTC never adequately established the degree of foreclosure occasioned by McWane's full support program. First, the Commission reasoned that *all* McWane sales to distributors subject to its full support program had been "foreclosed," via exclusive dealing, to McWane's competitors. That is incorrect. The sales opportunities foreclosed by McWane's

<sup>169</sup> *Id.* at 1, 9–11.

<sup>170</sup> *Id.* at 9.

<sup>171</sup> *Id.* at 22–29.

<sup>172</sup> *Id.* at 13.

<sup>173</sup> See Dissenting Statement of Commissioner Joshua D. Wright in Memorandum Opinion & Order, *In re McWane, Inc.*, F.T.C. File No. 9351, at 28–29 (Jan. 30, 2014), [http://www.ftc.gov/system/files/documents/public\\_statements/202211/140206mcwanestatement.pdf](http://www.ftc.gov/system/files/documents/public_statements/202211/140206mcwanestatement.pdf). [hereinafter Wright Dissent].

<sup>174</sup> *Id.* at 31–32.

<sup>175</sup> *Id.* at 32.

<sup>176</sup> *Id.*

full support policy were only the “contestable” sales—that is, those that *would have been made* to other sellers but for the policy.<sup>177</sup> Moreover, the Commission made no effort to quantify the sales made to McWane’s rivals under the two exceptions to McWane’s full support policy.<sup>178</sup> Such sales were obviously not foreclosed to McWane’s rivals, but the Commission essentially ignored them.<sup>179</sup> Absent information on the number of contestable sales and the volume of distributor purchases under exceptions to the full support program, it is simply impossible to assess the degree of foreclosure occasioned by the policy.

Not only did the Commission disregard deficiencies in the affirmative case against McWane, it also ignored several pieces of evidence suggesting that McWane’s exclusive dealing was not anticompetitive. First, the full support program did not require a commitment of exclusivity for any period of time; distributors purchasing from McWane could begin carrying rival brands at any point (though doing so might cause McWane to refuse to sell to them in the future).<sup>180</sup> Courts have often held that short-duration exclusive dealing arrangements are less troubling than longer-term agreements;<sup>181</sup> indeed, a number of courts presume the legality of exclusive dealing contracts of a year or less.<sup>182</sup> McWane’s policy was of *no*, not just short, duration.

Second, entry considerations suggested an absence of anticompetitive harm here. If entry into a market is easy, there is little need to worry that exclusionary conduct will produce market power. Once the monopolist begins to exercise its power by reducing output and raising price, new entrants will appear on the scene, driving price and output back to competitive levels. The recent and successful entry of both Star and Sigma, who collectively gained about half the

<sup>177</sup> *Id.* at 38–40. For example, if a distributor, absent the full support policy, would have purchased 70 units from McWane and 5 units from Star but, because of the full support program, purchased all 75 units from McWane, the full support program effectively foreclosed Star from 5 units of sales, not 75 units.

<sup>178</sup> *Id.* at 40–41.

<sup>179</sup> For example, if a distributor that carried McWane’s products (and was thus subject to the full support policy) purchased 70 domestic fittings from McWane and 30 fittings from other producers pursuant to one of the full support program’s exceptions, the Commission counted 100 units of foreclosed sales.

<sup>180</sup> Wright Dissent, *supra* note 172, at 43.

<sup>181</sup> *See, e.g., Omega Envtl., Inc. v. Gilbarco, Inc.*, 127 F.3d 1157, 1163 (9th Cir. 1997) (observing that “the short duration and easy terminability of [certain exclusive] agreements negate substantially their potential to foreclose competition”); *W. Parcel Express v. United Parcel Serv. of America, Inc.*, 190 F.3d 974, 976 (9th Cir. 1999) (concluding that “termination provisions that allowed a customer to terminate the contract for any reason with very little notice” were relevant to upholding agreements).

<sup>182</sup> *See, e.g., Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039, 1059 (8th Cir. 2000); *U.S. Healthcare, Inc. v. Healthsource, Inc.*, 986 F.2d 589, 596 (1st Cir. 1993); *CDC Techs., Inc. v. IDEXX Lab., Inc.*, 186 F.3d 74 (2d Cir. 1999); *Thompson Everett, Inc. v. Nat’l Cable Adver.*, 57 F.3d 1317, 1325 (4th Cir. 1995); *Roland Machinery v. Dresser Industries*, 749 F.2d 380, 395 (7th Cir. 1984).

total market share within a short period of time, suggested that entry into the pipe fittings market is easy.<sup>183</sup>

Finally, evidence of actual market performance indicated that McWane's exclusive dealing policies did not generate anticompetitive effect. McWane enforced its full support program for the first year of Star's participation in the domestic fittings market, but not thereafter. Star's growth rate, however, was exactly the same during the enforcement of the policy as it was both before the policy was implemented and after it ended.<sup>184</sup> That suggests that the program had no impact on rivals' ability to enter the market and grow their business, in which case it could not be anticompetitive.<sup>185</sup>

The Commission also virtually ignored a procompetitive justification for McWane's full support policy. McWane produced a complete "system"—a full line of domestic pipe fittings—comprised of disparate but complementary parts. Both distributors and end-users have an interest in having ready access to all the parts in such a system, and a vertical interbrand restraint like McWane's full support policy may help ensure such access. Because McWane's fixed costs (for example, the cost of casting a die) were similar for both rarely used fittings and popular fittings, McWane's average production cost for a rarely used fitting [that is, (fixed costs + variable costs) ÷ number of units produced] was higher than its average cost for an oft-used part. That meant that, if McWane charged similar prices for technologically similar parts—a pricing practice purchasers often expect—it needed to "subsidize" production of rarely-used fittings with margins earned on popular parts. An equally efficient producer of only popular fittings would not have to engage in such "cross-subsidization" to finance the production of rarely used parts and would be able to sell its popular fittings at a lower price. But if too many buyers purchased their often-used fittings from the partial line producer, McWane could no longer afford to produce rarely used parts, and gaps in product availability would result.<sup>186</sup>

<sup>183</sup> Wright Dissent, *supra* note 172, at 44–45.

<sup>184</sup> *Id.* at 45.

<sup>185</sup> As Commissioner Wright explained,

Neither Complaint Counsel nor the Commission attempt[ed] to explain how growth that is equal with and without the Full Support Program is consistent with [the Commission's] theory of harm that the Program raised Star's costs of distribution and impaired competition. The most plausible inference to draw from these particular facts is that the Full Support Program had almost no impact on Star's ability to enter and grow its business, which, under the case law, strongly counsels against holding that McWane's conduct was exclusionary.

*Id.* at 45–46.

<sup>186</sup> The Commission maintained that, if other producers started underselling McWane on popular parts, McWane could reduce its price to meet theirs and then set a separate price for low-volume parts, charging enough to cover the fixed costs of producing those parts. *See* Opinion of the Commission, *supra* note 167, at 32. But McWane may have had good business reasons to prefer a cross-subsidization strategy to such a separate pricing approach. First, consumers may have been put off by having to pay substantially higher prices for



McWane's Full Support Program offered a solution to this problem. By requiring buyers of its fittings to refrain from handling those of other producers, McWane could prevent the sort of "cherry-picking" that would have rendered its production of obscure parts uneconomical. Because consumers, distributors, and even other producers of domestic iron pipe fittings all benefit from continued production of a full line of fittings, McWane's full support program was far from an unreasonable form of competition. On the contrary, it was output-enhancing and thus procompetitive.

In the end, the FTC's *McWane* decision failed to require adequate evidence in support of the articulated theory of anticompetitive harm, ignored actual market evidence suggesting an absence of such harm, and gave short shrift to an important procompetitive benefit of McWane's exclusive dealing. The Commission's apparent and unjustified hostility toward vertical interbrand restraints like those that McWane implemented is likely to discourage their use—despite their general efficiency—and thereby enhance Type I error costs.

### c. *Graco*

In April 2013, the FTC settled a challenge to a company's acquisitions of two key rivals.<sup>187</sup> The defendant was Graco, the leading manufacturer of "fast set equipment" (FSE) used by contractors to apply polyurethane foams and coatings. In 2005 and 2008, Graco purchased its two closest competitors, eliminating almost all competition in the North American market for FSE.<sup>188</sup> Following the acquisition, the combined company allegedly coerced and threatened FSE distributors so that they would not carry competitors' products.<sup>189</sup> It also filed a questionable lawsuit against a rival, Gama/PMC, causing FSE

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technologically similar obscure parts. McWane had an interest in preserving its buyers' goodwill. In addition, a cross-subsidization strategy may have provided greater certainty than separate pricing and thereby reduced McWane's costs. When deciding whether to incur the fixed costs necessary to produce an obscure part, a business planner does not know how many of those units it will eventually sell and thus how to price the units to ensure coverage of fixed costs. If it sets the price too low, it will not recoup its fixed costs; if it prices too high, it will encourage substitution away from the unit. Production of the part will involve less business risk if the producer can recoup its costs in a manner that is more predictable—that is, by collecting a small increment on parts whose demand is more predictable. If production risk is lower, production is more likely to occur. Thus, the sort of cross-subsidization via full-line forcing that McWane implemented may encourage greater production.

<sup>187</sup> See Press Release, FTC, Graco, Inc. Settles FTC Charges That Its Acquisitions Illegally Harmed Competition in the U.S. Market for Fast Set Equipment (Apr. 18, 2013), <http://www.ftc.gov/news-events/press-releases/2013/04/graco-inc-settles-ftc-charges-its-acquisitions-illegally-harmed>. Each acquisition failed to meet the threshold requirement for reporting under governing premerger notification requirements. *Id.*

<sup>188</sup> See Complaint, *In re Graco, Inc.*, F.T.C. Docket No. C-4399, at ¶¶ 17–18, 27–30 (Apr. 17, 2013), <http://www.ftc.gov/sites/default/files/documents/cases/2013/04/130418gracompt.pdf>.

<sup>189</sup> *Id.* ¶ 9.

distributors to grow leery of that supplier and drop its products.<sup>190</sup> Those post-acquisition actions helped cement Graco's market power by denying its actual and potential rivals access to the distribution networks they needed to effectively market their products.

In light of Graco's post-acquisition conduct, the FTC's consent order sensibly prohibited Graco from threatening, coercing, or retaliating against distributors that carry its rivals' products.<sup>191</sup> It also required settlement of the lawsuit that was impairing Gama/PMC's access to distributors, and it forbade Graco from bringing a similar suit in the future.<sup>192</sup> But the order then went further. It prohibited Graco from entering into exclusive dealing contracts with distributors, and it placed limits on Graco's freedom to give loyalty discounts to distributors.<sup>193</sup>

There was, however, no evidence that those last forbidden activities—exclusive dealing arrangements and loyalty discounts—contributed to the absence of competition in the FSE market. Because exclusive dealing arrangements and loyalty discounts are usually procompetitive,<sup>194</sup> prohibiting their use by Graco in the absence of evidence that they were responsible for the lack of competition in the market, or were likely to be used to effect future anticompetitive harm, was more likely to hurt than help consumers.<sup>195</sup>

As the Commission acknowledged, the market for FSE is precisely the sort market in which exclusive dealing arrangements achieve the procompetitive benefit of avoiding “interbrand free-riding.”<sup>196</sup> Manufacturers of FSE will enhance total sales if they train distributors on the proper use and various complicated features of FSE. Consumers benefit from (and sales are increased by) such training, because the distributors pass along their learning to end-user purchasers. But if one FSE manufacturer trains a distributor on how to use the

<sup>190</sup> *Id.* ¶ 10.

<sup>191</sup> See Decision and Order, *In re Graco, Inc.*, F.T.C. Dkt. No. C-4399, at § III.A.5, 7 (Apr. 17, 2013); *id.* at 8, § III.B. Because the acquired companies had been fully integrated into the acquirer, and all distinct operations had been shut down, it was impossible for the Commission to “unscramble the eggs” by imposing a structural remedy that separates the companies or parts thereof. The Commission therefore opted for a behavioral remedy—that is, a list of restrictions on how the combined company could operate its business in the future. The purported goal of the behavioral remedy was to enhance consumer welfare by restoring competition that was destroyed by the anticompetitive acquisitions.

<sup>192</sup> *Id.* § II, at 5–6.

<sup>193</sup> *Id.* §§ III.A.1, 2, 3, 4 & 6, at 6–7. Specifically, the order limited the purchase and inventory levels upon which Graco may condition distributor discounts. *Id.* at 7, § III.A.6.c.

<sup>194</sup> See *supra* notes 148–154 and accompanying text.

<sup>195</sup> See Statement of Commissioner Joshua D. Wright, *In re Graco*, F.T.C. File No. 101–0215, at 3 (Apr. 17, 2013), <http://www.ftc.gov/sites/default/files/documents/cases/2013/04/130418-gracowrightstatement.pdf>.

<sup>196</sup> See *id.* (“[T]he Commission’s Complaint describes the fast-set equipment market as one particularly well suited for exclusive arrangements. Specifically, the Complaint acknowledges the sale of fast-set equipment demands specialized third party distributors that possess the technical expertise to teach consumers how to use and maintain the manufacturer’s equipment.”).

equipment, other manufacturers whose product is carried by that distributor will not need to do so themselves. The possibility that they will take a free-ride at the expense of the manufacturer providing the training tends to dissuade *all* manufacturers from providing such training, to the detriment of consumers. Exclusive dealing or a loyalty discount that achieves near exclusivity may prevent extensive free-riding and thereby assure a manufacturer that it will receive the full benefit of its training efforts.<sup>197</sup> By forbidding exclusive dealing and loyalty discounts, then, the Commission's consent order threatened to cause a consumer injury, and there was no reason to take such risk absent evidence that exclusive dealing had been used, or was likely to be used in the future, to create anticompetitive harm.<sup>198</sup> To avoid Type I error costs, the consent order should have limited the behavioral remedy to actions that had contributed to the anticompetitive situation at hand; it should not have banned behaviors that had played no such role and were likely to benefit consumers.

### C. Intellectual Property Rights and Technology Standards

In recent years, the antitrust enforcement agencies have sought to use antitrust (including unfair competition law)<sup>199</sup> to constrain the exercise of certain intellectual property rights that have been incorporated into technological standards. This trend departs from prior policy, in place since 1995, pursuant to which the agencies treated intellectual property the same as conventional forms of property.<sup>200</sup> The agencies' purported goal in invoking antitrust in this context is to police anticompetitive "hold-up" by holders of patents that must

<sup>197</sup> *Id.* ("One could therefore easily imagine that manufacturers might only be willing to provide training to distributors if they have some assurance that current or future competitors will be unable to free ride on their investments in the distributors' technical expertise. Exclusive dealing arrangements with distributors are one well-known and common method of preventing such free riding.").

<sup>198</sup> It is important to note that excluding exclusive dealing and loyalty discounts from the list of behaviors prohibited by the consent order would not have given Graco free rein to use those practices in a manner causing anticompetitive foreclosure. The Commission or a competitor could always challenge a future exclusive dealing arrangement or loyalty discount if there were evidence that the practice had caused anticompetitive harm. The remainder of the Commission's behavioral remedy assured that there would be a viable competitor—Gama/PMC—that would be in a position to challenge any such conduct, and, in light of the consent order, the Commission and any reviewing court would take any future complaints quite seriously.

<sup>199</sup> Some of the agency conduct discussed here was taken pursuant to section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45(a), which enables the FTC to police "unfair methods of competition" even when they would not constitute standalone violations of the Sherman Act. *See infra* note 99. Within this subpart, we refer to section 5 actions as antitrust actions.

<sup>200</sup> U.S. DEPARTMENT OF JUSTICE & FEDERAL TRADE COMMISSION, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY § 2.1 (1995) ("Agencies apply the same general antitrust principles to conduct involving intellectual property that they apply to conduct involving any other form of tangible or intangible property ...").

be licensed by manufacturers of products employing standardized technologies. Other bodies of law, though, are capable of preventing anticompetitive hold-up and are less likely to deter valid exercises of intellectual property rights. Because the agencies' aggressive use of antitrust in this context provides little marginal deterrence of anticompetitive conduct while threatening to deter efficient exercises of intellectual property rights, it is likely to increase Type I error costs without reducing Type II error costs, thereby raising error costs overall.

To understand the agencies' position, some familiarity with the alphabet soup of SSOs, SEPs, and FRAND commitments is in order. A great many products—mobile telephones and DVD players, for example—are worth more to consumers if they can operate with products made by competing manufacturers. In light of the great consumer value created by common technological standards that permit interoperability among competing brands, “standard-setting organizations” (SSOs) have emerged to determine which technologies will be incorporated into particular standards (for example, those standards that will comprise the 4G protocol for mobile telephony).<sup>201</sup> Because most technology standards include multiple patented aspects, implementation of a particular technological standard is likely to require the licensing of numerous “standard-essential” patents (SEPs).

That creates potential for mischief. If a SEP holder can get its technology implemented and widely adopted, it may then be in a good position to demand higher royalties from implementers that would otherwise face great switching costs.<sup>202</sup> To mitigate such hold-up problems, SSOs usually procure agreements in which SEP holders commit up front to issue licenses on “reasonable and non-discriminatory” (RAND) or “fair, reasonable, and non-discriminatory” (FRAND) terms.<sup>203</sup> A producer implementing some SSO-established standard can be assured that SEP holders will not unreasonably increase their royalty demands once the producer has become “locked in” to the technological standard.

<sup>201</sup> For an overview of the role of standard setting, see ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS COMPETITION COMMITTEE, WORKING PARTY NO. 2 ON COMPETITION AND REGULATION, DAF/COMP/WP2/WD(2010)28, <https://www.ftc.gov/sites/default/files/attachments/us-submissions-oced-and-other-international-competition-fora/usstandardsetting.pdf>.

<sup>202</sup> See, e.g., Mark Lemley & Carl Shapiro, *Patent Holdup and Royalty Stacking*, 85 TEX. L. REV. 1991, 1992–93 (2007); Joseph Farrell, John Hayes, Carl Shapiro & Theresa Sullivan, *Standard Setting, Patents, and Hold-Up*, 74 ANTITRUST L.J. 603 (2007); U.S. DEPARTMENT OF JUSTICE & U.S. FEDERAL TRADE COMMISSION, ANTITRUST ENFORCEMENT AND INTELLECTUAL PROPERTY RIGHTS: PROMOTING INNOVATION AND COMPETITION 35–36 (2007) [hereinafter 2007 DOJ-FTC Report].

<sup>203</sup> 2007 FTC-DOJ Report, *supra* note 201, at 46–47. The RAND and FRAND terms are essentially equivalent; FRAND is more frequently used in Europe and RAND is more frequently used in the United States. See F/RAND, IT Law Wiki, <http://itlaw.wikia.com/wiki/F/RAND> (last visited March 12, 2015).

So what happens if a SEP holder files or threatens a lawsuit seeking injunctive relief or an exclusion order against an infringing adopter of the standard? The enforcement agencies have taken the position that enforcing one's intellectual property rights in such fashion may constitute an antitrust violation. In an action against appliance manufacturer Bosch, for example, the FTC claimed that a SEP holder's pursuit of injunctive relief amounted to an unfair method of competition.<sup>204</sup> Then, in an ultimately settled action against Motorola and its acquirer, Google, the Commission asserted that Motorola "breached its FRAND obligations by seeking to enjoin and exclude implementers of its SEPs;" that parent company Google "used ... threats of exclusion orders and injunctions to enhance its bargaining leverage against willing licensees;" and that "Motorola filed, and Google prosecuted, patent infringement claims before the United States International Trade Commission."<sup>205</sup> As Commissioner Wright and Judge Douglas Ginsburg have observed, "These complaints and consent orders, taken together, logically and necessarily depend upon the presumption that protecting a valid SEP against infringement by obtaining injunctive relief is itself anticompetitive."<sup>206</sup>

The FTC also seems to have taken the position that it is anticompetitive for a SEP holder to seek renegotiation of the royalties paid to it by a producer utilizing the standard. Consider, for example, the Commission's complaint in *In re Negotiated Data Solutions, LLC*.<sup>207</sup> The predecessor of defendant N-Data was the assignee of patents that had been incorporated into the technological standard for Fast Ethernet. Before the standard was established, the then-holder of the patents agreed that if its patents were incorporated into the standard, they would be licensed for a low fee.<sup>208</sup> After the patents were assigned, though, the assignee began to struggle financially and sought to renegotiate its license fees.<sup>209</sup> Specifically, it demanded licensees pay reasonable and

<sup>204</sup> Complaint, *In re Robert Bosch GmbH*, ¶ 20, Dkt. No. C-4377, 2012 WL 5944820 (Nov. 21, 2012).

<sup>205</sup> Complaint, *In re Motorola Mobility LLC*, ¶¶ 25–26, Dkt. No. C-4410, 2013 WL 3944149 (July 23, 2013).

<sup>206</sup> Joshua D. Wright & Douglas H. Ginsburg, *Whither Symmetry? Antitrust Analysis of Intellectual Property Rights at the FTC and DOJ*, 9 COMPETITION POL'Y INT'L 41 (2013). DOJ similarly appears to have adopted the view that pursuit of an injunction or exclusion order by the holder of a FRAND-encumbered SEP constitutes anticompetitive conduct. See *id.* at 14–15; UNITED STATES DEPARTMENT OF JUSTICE & UNITED STATES PATENT & TRADEMARK OFFICE, POLICY STATEMENT ON REMEDIES FOR STANDARDS-ESSENTIAL PATENTS SUBJECT TO VOLUNTARY F/RAND COMMITMENTS 6 (2013) (endorsing the view that an exclusion order based on a SEP generally should not be granted because "[a] decision maker could conclude that the holder of a F/RAND encumbered SEP had attempted to use an exclusion order to pressure an implementer of a standard to accept more onerous licensing terms than the patent holder would be entitled to receive consistent with the F/RAND commitment").

<sup>207</sup> Complaint, *In re Negotiated Data Solutions LLC*, No. C-4234 (Sept. 22, 2008), <http://www.ftc.gov/sites/default/files/documents/cases/2008/09/080923ndscomplaint.pdf>.

<sup>208</sup> *Id.* ¶¶ 13–14.

<sup>209</sup> *Id.* ¶¶ 25–29.

non-discriminatory royalties, rather than the low fee the original patent holder had agreed to.<sup>210</sup> Based on that conduct, the FTC brought (and settled) an unfair methods of competition suit against the assignee, citing hold-up concerns.<sup>211</sup> Given that neither the original patent holder nor the assignee ever engaged in any deception or other improper behavior in an effort to have the patents incorporated into the relevant technological standard,<sup>212</sup> the Commission's position seems to be that a mere effort to renegotiate the terms for licensing a SEP constitutes anticompetitive conduct.

Whereas the enforcement agencies have sought to use antitrust to police injunctive actions and attempted license renegotiations by SEP holders, other bodies of law appear capable of preventing anticompetitive hold-up. Consider first an action for injunctive relief. Patent law would require the SEP holder to establish that: (1) it has suffered an irreparable injury; (2) remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) the balance of hardships between itself and the infringer warrant an equitable remedy (for example, an injunction); and (4) the public interest would not be disserved by a permanent injunction.<sup>213</sup> Succeeding under this test would be quite difficult for a SEP holder that was just seeking to gain bargaining leverage so as to enhance its royalties.<sup>214</sup> The SEP holder's agreement to license on FRAND terms would be evidence that the first and second factors are not met because any injury is reparable and monetary damages would be adequate. Even if such evidence were rebutted, the fourth factor—public interest—would call for judges to deny injunctions sought as part of a hold-up strategy aimed at extracting extra surplus. Accordingly, as Justice Kennedy explained, the basic patent law standards governing the granting of injunctive relief can effectively prevent hold-up injunctions:

When the patented invention is but a small component of the product the companies seek to produce and the threat of an injunction is employed simply for undue leverage in negotiations, legal damages may well be sufficient to compensate for the infringement and an injunction may not serve the public interest.<sup>215</sup>

When it comes to the second scenario of concern (that is, that a SEP holder seeks to renegotiate the royalties paid to it by a producer utilizing the standard), basic contract law would appear to prevent hold-up harm. Although an

<sup>210</sup> *Id.* ¶¶ 27–28.

<sup>211</sup> *See id.* ¶ 32 (asserting hold-up theory); Decision and Order, *In re Negotiated Data Solutions LLC*, Dkt. No. C-4234 (Sept. 22, 2008), <http://www.ftc.gov/sites/default/files/documents/cases/2008/09/080923ndsdo.pdf>.

<sup>212</sup> *Compare* *Rambus, Inc. v. FTC*, 522 F.3d 456, 463–57 (D.C. Cir. 2008).

<sup>213</sup> *See eBay v. MercExchange, LLC*, 547 U.S. 388, 391 (2006).

<sup>214</sup> *See generally* Douglas H. Ginsburg, Taylor M. Owings & Joshua D. Wright, *Enjoining Injunctions: The Case Against Antitrust Liability for Standard Essential Patent Holders Who Seek Injunctions*, ANTITRUST SOURCE, Oct. 2014, at 2–5.

<sup>215</sup> *eBay*, 547 U.S. at 396–97 (Kennedy, J., concurring).

initial licensing commitment (for example, an agreement to license on FRAND terms) runs between the SEP holder and the relevant SSO, any licensee implementing the standard at issue is an intended third-party beneficiary of the commitment and should be able to enforce it. The legal question, then, would be whether there is a basis in contract law for permitting renegotiation of terms. A well-developed body of doctrine, exemplified by sections 89, 175, and 176 of the Restatement (Second) of Contracts and section 2-209 of the Uniform Commercial Code, governs this issue.<sup>216</sup> In general, the doctrine permits renegotiation only if there is a good faith basis for changing the terms at issue (for example, a market shift).<sup>217</sup> Contract law is thus capable of precluding SEP holders from renegotiating royalties on FRAND-encumbered patents as part of a hold-up strategy aimed at extracting extra surplus.<sup>218</sup>

In light of the degree to which basic patent and contract doctrines can eliminate hold-up by holders of FRAND-encumbered SEPs, what role should antitrust law play in policing injunctive actions and attempted royalty renegotiations by such patent holders? If one takes seriously the limits of antitrust, it should play only a very small role.

Successful antitrust actions result in treble damages.<sup>219</sup> One justification for that rule is that, because many antitrust violations occur in secret and are thus not successfully prosecuted, to get optimal deterrence, the punishment for an antitrust violator must be multiplied by the inverse of the likelihood of detection and successful prosecution (thus, if there is a one-in-three chance of successful prosecution, damages should be multiplied by three to make the expected value of a violation equal zero).<sup>220</sup> For antitrust violations that do not occur in secret, however, treble damages are not needed for optimal deterrence and will tend to overdeter.<sup>221</sup> A SEP holder's lawsuit for injunctive relief or attempted renegotiation of royalties on a FRAND-encumbered patent is open and notorious conduct. Antitrust's mandatory trebling of damages is thus likely to overdeter here—an unfortunate result that is wholly unnecessary given

<sup>216</sup> See RESTATEMENT (SECOND) OF CONTRACTS §§ 89 (1981) (“Modification of Executory Contract”), 175 (“When Duress by Threat Makes a Contract Voidable”), 176 (“When a Threat Is Improper”); Uniform Commercial Code § 2-209 (2012) (“Modification, Rescission and Waiver”).

<sup>217</sup> See, e.g., U.C.C. § 2-209, cmt. 2 (2012) (observing that “such matters as a market shift which makes performance come to involve a loss may provide such a reason [for modification of an executory contract] even though there is no such unforeseen difficulty as would make out a legal excuse from performance ...”); RESTATEMENT (SECOND) OF CONTRACTS § 89, cmt. b (1981) (provision is intended to permit modifications that are “fair and equitable”).

<sup>218</sup> See generally Bruce H. Kobayashi & Joshua D. Wright, *The Limits of Antitrust and Patent Holdup: A Reply to Cary et al.*, 78 ANTITRUST L.J. 505, 523 (2012) (“[C]ontract law is both better suited to the identification and regulation associated with patent holdup than is antitrust and more likely to reduce transaction costs and welfare losses.”).

<sup>219</sup> 15 U.S.C. § 15 (providing for treble damages in private antitrust actions).

<sup>220</sup> See generally HOVENKAMP, *supra* note 114.

<sup>221</sup> See *id.* at 721.

that other bodies of law (patent and contract) are capable of preventing hold-up problems.<sup>222</sup>

One may retort that there is no need to worry about overdeterrence in this context because the optimal level of injunctions and royalty renegotiations by holders of FRAND-encumbered SEPs is zero.<sup>223</sup> That is incorrect. Both sorts of conduct may constitute legitimate means of protecting property rights and may thus be procompetitive. For example, a holder of a FRAND-encumbered SEP might legitimately seek injunctive relief to enforce its patent if the infringer were judgment-proof or had rejected (or expressed an intention to reject) a FRAND royalty.<sup>224</sup> Alternatively, the SEP holder might legitimately try to renegotiate its royalties in light of some market shift that undermines the original royalty rate.<sup>225</sup> In light of these procompetitive reasons for holders of FRAND-encumbered SEPs to seek injunctive relief or royalty renegotiation, the enforcement agencies' insistence on invoking antitrust (with its treble damages) to police such efforts is likely to produce significant overdeterrence and thus Type I error costs.<sup>226</sup> And those error costs are unlikely to be offset by a reduction in Type II (underdeterrence) error costs, because patent and contract rules are fully capable of preventing instances of anticompetitive hold-up.

As FTC actions have inappropriately raised antitrust risks faced by holders of FRAND-encumbered SEPs, the DOJ has acted unwisely to limit the ability of FRAND-encumbered SEP owners to obtain reasonable returns to their patent rights. In a February 2, 2015 business review letter,<sup>227</sup> DOJ informed a prominent technical standards body, the Institute of Electrical and Electronics Engineers (IEEE), that it had no plans to bring an antitrust enforcement action against that SSO's proposed patent policy changes, which were then

<sup>222</sup> See Kobayashi & Wright, *supra* note 217, at 508–11.

<sup>223</sup> See, e.g., George S. Cary, Mark W. Nelson, Steven J. Kaiser & Alex R. Sistla, *The Case for Antitrust Law to Police the Patent Holdup Problem in Standard Setting*, 77 ANTITRUST L.J. 913, 932 (2011) (asserting that it is “unclear what would constitute a false positive in the context of SSO-patent holdup” and describing conduct reachable as patent holdup by the antitrust laws as “unlikely to be defended as efficient”).

<sup>224</sup> See Ginsburg, Owings & Wright, *supra* note 213, at 5 (“[A] SEP holder may require injunctive relief against [a] SEP holder that is or appears or claims to be judgment proof or consistently and in bad faith rejected FRAND terms to gain leverage in negotiations by putting the SEP holder to the need for costly litigation.”).

<sup>225</sup> See Kobayashi & Wright, *supra* note 217, at 523–24.

<sup>226</sup> This is true even if the antitrust action is brought under section 5 of the FTC Act, which cannot be privately enforced by plaintiffs seeking treble damages. A successful Section 5 action may give rise to copycat private actions under sections 1 or 2 of the Sherman Act or under privately enforceable state antitrust laws (including so-called “little FTC Act” statutes, many of which may be enforced in private actions). See Kobayashi & Wright, *supra* note 217, at 509 n.15.

<sup>227</sup> Letter from Renata B. Hesse, Acting Assistant Att’y Gen., U.S. Department of Justice, to Michael A. Lindsey, Esq., Dorsey & Whitney LLP (Feb. 2, 2015), <http://www.justice.gov/atr/public/busreview/311470.htm>. [hereinafter 2015 DOJ Letter].



officially adopted on February 8.<sup>228</sup> These changes, unlike other standard setting policies that were the subjects of favorable DOJ business review letters,<sup>229</sup> greatly devalue SEPs and thereby undermine incentives to make patents available for use in IEEE standards.<sup>230</sup>

The new IEEE policy makes a number of significant policy changes. First, any patentee seeking to have its patent(s) included in an IEEE standard must provide the IEEE with a letter of assurance waiving its right to seek an injunction against an infringer. The new policy also specifies that an analysis of comparable licenses for purposes of determining a FRAND royalty can only consider licenses for which the SEP holder has relinquished the right to seek and enforce an injunction against an unlicensed implementer. Moreover, the policy provides that a SEP holder may seek an injunction only after having fully litigated its claims against an unlicensed implementer (even an infringer that steadily refuses to negotiate a license) through the first level appeals stage—a process which would essentially render injunctive relief highly impractical if not futile.<sup>231</sup> In

<sup>228</sup> Press Release, IEEE Statement Regarding Updating of Its Standards-Related Patent Policy (Feb. 8, 2015), [https://www.ieee.org/about/news/2015/8\\_february\\_2015.html](https://www.ieee.org/about/news/2015/8_february_2015.html).

<sup>229</sup> In a 2006 letter to the VMEbus International Trade Association (“VITA”), the DOJ concluded that a policy under which VITA members would be required to disclose their most restrictive licensing terms would preserve *ex ante* competition among alternative technologies. See Letter from Thomas O. Barnett, Assistant Att’y Gen., U.S. Department of Justice, to Robert A. Skitol, Esq. (Oct. 30, 2006), <http://www.justice.gov/atr/public/busreview/219380.pdf>. In a 2007 letter to IEEE, DOJ similarly had no objection to a proposed IEEE policy that would allow patentees to make voluntary assurances about their intended maximum royalty rates and most restrictive licensing terms. DOJ found that those policies would stimulate competition for inclusion in the standard and speed up the development, implementation, and adoption of IEEE standards. See Letter from Thomas O. Barnett, Assistant Att’y Gen., U.S. Department of Justice, to Michael A. Lindsay, Esq., Dorsey & Whitney LLP (Apr. 30, 2007), <http://www.atrnet.gov/subdocs/222978.pdf>. In sum, the VITA and 2007 IEEE proposals enabled individual SSO participants to reveal and commit to certain individual licensing terms that they had *individually* selected, thereby reducing the scope of negotiating uncertainty and facilitating mutually-beneficial bargains free from regulatory dictates. In marked contrast, the new 2015 IEEE policy substantially interferes in the scope for negotiating over key bargaining terms affecting compensation, thereby drastically constraining contractual freedom.

<sup>230</sup> For a critical evaluation of the 2015 DOJ business review letter, see, e.g., Stuart M. Chemtob, *Carte Blanche for SSOs? The Antitrust Division’s Business Review Letter on the IEEE’s Patent Policy Update*, 3 CPI ANTITRUST CHRONICLE, Mar. 2015, at 1, 1–10. For a critique of the new IEEE patent policy, see Alden F. Abbott, *Patent Policy Change Would Undermine Property Rights and Innovation*, HERITAGE FOUNDATION LEGAL MEMORANDUM, no. 147, Mar. 4, 2015, <http://www.heritage.org/research/reports/2015/03/patent-policy-change-would-undermine-property-rights-and-innovation>.

<sup>231</sup> In *eBay Inc. v. MercExchange, L.L.C.*, the Supreme Court held that a patentee’s request for an injunction should be evaluated under the four-factor equitable standard traditionally used to determine if an injunction should issue. See 547 U.S. 388 (2006). Although this holding makes it difficult for the holder of a SEP to obtain an injunction, it does not eliminate injunctive relief. U.S. courts have never held that an injunction may never be obtained by a SEP holder, for example, where the infringer has refused the SEP holder’s FRAND licensing offer. See *Apple, Inc. v. Motorola, Inc.*, 757 F.3d 1286, 1331 (Fed. Cir. 2014) (“To the extent that the district court applied a *per se* rule that injunctions are unavailable for SEPs, it erred.”).

addition, the new policy precludes a SEP holder from conditioning a license on reasonable reciprocal access to non-SEP patents held by the counterparty licensee.<sup>232</sup> Furthermore, key factors to be consulted in determining a “reasonable” royalty rate for a SEP include the SEP’s contribution to the value of the smallest saleable unit that practices the SEP, the value contributed to that unit in light of all of the SEPs practiced by the unit, and the terms of only those existing licenses covering use of the SEP that were *not* obtained under the threat of injunctive remedies. These factors straitjacket licensor-licensee negotiations. They “all weigh in the direction of lowering royalty rates; other ... factors that might weigh in the other direction are noticeably absent from the list.”<sup>233</sup> The benefit that a claimed invention provides to an end product may in certain circumstances be a better measure of SEP value added than the benefit conferred upon the smallest saleable unit (for example, a small microchip).<sup>234</sup> A blinkered focus

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Thus, by effectively preventing a SEP holder from obtaining viable injunctive relief, the new IEEE policy undermines a valuable right that continues to be recognized by the judiciary. The new IEEE policy also effectively precludes SEP holders from filing a petition with the U.S. International Trade Commission (ITC) for exclusion of infringing goods pursuant to section 337 of the Tariff Act of 1930 (19 U.S.C. § 1337), despite the fact that the ITC has never indicated that it will not issue exclusion orders based on the infringement of SEPs. Remarkably, this bar to exclusion order relief also is inconsistent with publicly proclaimed DOJ and U.S. Patent and Trademark Office (PTO) policy (a fact not noted in the 2015 business review letter). In a 2013 joint statement, the DOJ and the PTO opined that the ITC might properly issue an exclusion order benefiting a F/RAND-encumbered patent, where, for example, an implementer refuses to pay what has been determined to be a FRAND royalty or refuses to engage in negotiations to determine FRAND terms. See U.S. DEPARTMENT OF JUSTICE AND U.S. PATENT & TRADEMARK OFFICE, POLICY STATEMENT ON REMEDIES FOR STANDARDS-ESSENTIAL PATENTS SUBJECT TO VOLUNTARY F/RAND COMMITMENTS (2013), <http://www.justice.gov/atr/public/guidelines/290994.pdf>.

<sup>232</sup> This arbitrary condemnation of reciprocity in licensing undermines the ability of SEP holders to obtain value through mutually beneficial contracts. Moreover, since it eschews the evaluation of case-specific competitive effects, it is at odds with the well-established views of U.S. antitrust enforcers that cross-licensing may engender substantial efficiencies (for example, it can facilitate integration of the licensed property with complementary factors of production, benefiting consumers through the reduction of costs and the introduction of new products) and should be evaluated under the antitrust rule of reason, which takes into account potential efficiencies and anticompetitive effects. See U.S. DEPARTMENT OF JUSTICE & FEDERAL TRADE COMMISSION, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY §§ 2.3, 3.4 (1995), <http://www.justice.gov/atr/public/guidelines/0558.htm>.

<sup>233</sup> Chemtob, *supra* note 230, at 4.

<sup>234</sup> Use of the smallest infringing component’s price as the royalty base may undercompensate a SEP holder for the SEP’s contributions to complementary components. See J. Gregory Sidak, *The Property Royalty Base for Patent Damages*, 10 J. COMPETITION L. & ECON. 989, 993–95 (2014). In *Lucent Technologies, Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1339 (Fed. Cir. 2009), the Federal Circuit stated that “sophisticated parties routinely enter into license agreements that base the value of the patented inventions as a percentage of the commercial products’ sales price.” Thus, in calculating a reasonable royalty, “[t]here is nothing inherently wrong with using the market value of the entire product, especially when there is no established market value for the infringing component or feature.” *Id.* at 1339.

on one SEP as a proportion of all SEPs within a unit ignores the fact that certain SEPs may be far more valuable than others<sup>235</sup>—a reality that would be revealed in arms’ length negotiations not limited by an artificial “proportionality” rule. Finally, a refusal to weigh prior licensing terms agreed to under the threat of a possible injunction potentially removes from consideration large numbers of licensing agreements that incorporated recognition of the patentee’s core right to exclude.<sup>236</sup>

All told, these new patent policy provisions encourage potential licensees to insist on anticompetitive terms that monopsonistically reduce returns to SEP holders below the competitive level—terms that, if agreed to jointly by the licensees, could well be deemed a *per se* illegal monopsony-buyer cartel (with the potential licensees buying license rights).<sup>237</sup> A failure to prosecute agreements of this sort, which is encouraged by the business review letter, harmfully raises Type II error.<sup>238</sup>

In the end, then, the agencies’ recent treatment of intellectual property rights, particularly those incorporated into technological standards, is inconsistent with a limits of antitrust approach. Using antitrust to police hold-up stemming from injunctive actions or renegotiation efforts by SEP holders provides little marginal benefit (given that patent law and contract law already police bad behavior here), while imposing significant marginal cost (given the

<sup>235</sup> Within an industry sector, the distribution of patent values is highly skewed, with some patents being extremely valuable, and many others having little value. See, e.g., Mark Schankerman, *How Valuable Is Patent Protection? Estimates by Technology Field*, 29 RAND J. ECON. 77 (1998); Gerald Silverberg & Bart Verspagen, *The Size Distribution of Innovations Revisited: An Application of Extreme Value Statistics to Citation and Value Measures of Patent Significance*, 139 J. ECONOMETRICS 318 (2007). Moreover, even though “most SEPs are likely entitled to only a relatively low royalty ... for a given standard there likely are a small number of SEPs that are entitled to a relatively large royalty. Some patented inventions provide important benefits and have no close substitutes. Qualcomm’s CDMA patents are an example.” Gregory K. Leonard & Mario A. Lopez, *Determining RAND Royalty Rates for Standard-Essential Patents*, 29 ANTITRUST 86 (2014), [http://www.edgeworthetheconomics.com/files/documents/Determining\\_RAND\\_Royalty\\_Rates\\_for\\_Standard-Essential\\_Patents.pdf](http://www.edgeworthetheconomics.com/files/documents/Determining_RAND_Royalty_Rates_for_Standard-Essential_Patents.pdf).

<sup>236</sup> The courts have not categorically eliminated the injunction as a possible remedy for a SEP holder, nor has the U.S. International Trade Commission sought to block SEP holders from petitioning it for exclusion orders applicable to infringing imports. See *supra* note 230.

<sup>237</sup> See *Mandeville Island Farms, Inc. v. Am. Crystal Sugar Co.*, 334 U.S. 219 (1948) (price fixing by purchasers *per se* illegal). See, e.g., *Todd v. Exxon Corp.*, 275 F.3d 191, 201 (2d Cir. 2001) (“a horizontal conspiracy among buyers to stifle competition is as unlawful as one among sellers”). The 2015 DOJ Letter states that the potential competitive benefits of the new policy likely outweigh any potential competitive harms, but it provides no support for this assertion. Moreover, it evinces no awareness of how the new policy inherently tends to reduce patent licensing fees below the competitive level by constraining the overall scope of negotiations. While the Letter notes that the new policy does not prevent patentees from suing for patent damages in the form of RAND (essentially equivalent to FRAND) compensation, it ignores the fact that taking injunctions off the table (among other restrictions) depresses returns to patentees, and that such depressed returns may well influence the analysis of courts in calculating RAND.

<sup>238</sup> It is most ironic and unfortunate that the FTC’s recent actions implicitly encourage inappropriate antitrust challenges to SEP holders, thus raising Type I error, whereas DOJ’s recent business review letter discourages appropriate antitrust challenges to anticompetitive behavior, thus raising Type II error.

likely overdeterrence resulting from potential antitrust liability). Respect for the limits of antitrust would call for the enforcement agencies to stay their hand. At the same time, using antitrust policy to encourage private bodies to take actions that devalue SEPs thwarts well-founded challenges to anticompetitive monopsonistic behavior. Such a perverse antitrust policy threatens to raise Type II error costs and is at odds with a limits of antitrust approach.

## D. Merger Policy

*The Limits of Antitrust*—Easterbrook’s article itself—said little about merger review, focusing more on violations of sections 1 and 2 of the Sherman Act (for example, horizontal and vertical trade restraints, exclusionary practices). But the article’s prescription—minimize the sum of error and decision costs—applies equally in the merger context. In at least three areas, the enforcement agencies appear not to be following a limits of antitrust approach.

### 1. Reliance on the GUPPI

In 2010, the DOJ and FTC revised their Horizontal Merger Guidelines, which detail how the agencies review proposed mergers to ensure that they will not substantially lessen competition in some line of commerce.<sup>239</sup> The purported goal of the revision was to reflect better the actual practices agencies follow in conducting pre-merger investigations.<sup>240</sup> Perhaps the most notable new emphasis in the revised guidelines was a move away from market definition, the traditional starting point for merger analysis, and toward consideration of potentially adverse “unilateral” effects—that is, anticompetitive harms that, unlike collusion or even non-collusive oligopolistic pricing, need not involve participation of any non-merging firms in the market.<sup>241</sup> The primary unilateral effect emphasized by the new guidelines is that the merger may put “upward pricing pressure” on brand-differentiated but otherwise similar products sold by the merging firms.<sup>242</sup> The guidelines maintain that when upward pricing pressure seems significant, it may be unnecessary to define the relevant market before concluding that an anticompetitive effect is likely.<sup>243</sup>

<sup>239</sup> U.S. DEPARTMENT OF JUSTICE & FEDERAL TRADE COMMISSION, HORIZONTAL MERGER GUIDELINES (2010) [hereinafter 2010 Merger Guidelines]. Section 7 of the Clayton Act prohibits a merger if “in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.” 15 U.S.C. § 18.

<sup>240</sup> 2010 Merger Guidelines, *supra* note 239, at 1.

<sup>241</sup> *Id.* at 20–24.

<sup>242</sup> *Id.* at 20–22.

<sup>243</sup> *Id.* at 7 (“The Agencies’ analysis need not start with market definition. Some of the analytical tools used by the Agencies to assess competitive effects do not rely on market definition.”); *id.* at 21 (“Where sufficient data are available, the Agencies may construct economic models designed to quantify the unilateral price effects resulting from the merger. . . . These merger simulation models need not rely on market definition.”).

The logic of upward pricing pressure is straightforward. Suppose five firms sell competing products (Products *A* through *E*) that, while largely substitutable, are differentiated by brand. Given the brand differentiation, some of the products are closer substitutes than others. If the closest substitute to Product *A* is Product *B* and vice-versa, then a merger between Producer *A* and Producer *B* may result in higher prices even if the remaining producers (*C*, *D*, and *E*) neither raise their prices nor reduce their output. The merged firm will know that if it raises the price of Product *A*, most of the lost sales will be diverted to Product *B*, which that firm also produces. Similarly, sales diverted from Product *B* will largely flow to Product *A*. Thus, the merged company, seeking to maximize its profits, may face pressure to raise the prices of Products *A* and/or *B*.

Section 6 of the 2010 Horizontal Merger Guidelines calls for upward pricing pressure to be assessed without considering, at least initially, the degree to which the merger may occasion efficiencies tending to *reduce* the merged firm's prices.<sup>244</sup> The guidelines thus contemplate the use of a "gross" upward pricing pressure index (GUPPI).<sup>245</sup> The GUPPI seeks to determine the likelihood, absent countervailing efficiencies, that the merged firm (for example, Producer *A* combined with Producer *B*) would seek to enhance its profits by raising the price of one of its competing products (for example, Product *A*), causing some of the lost sales on that product to be diverted to its substitute (for example, Product *B*).<sup>246</sup>

In assessing unilateral effects, a GUPPI would be calculated for each competing product sold by the merging firms (for example, there would be a

<sup>244</sup> *Id.* at 20–22.

<sup>245</sup> See Steven C. Salop, Serge Moresi & John R. Woodbury, *Scoring Unilateral Effects with the GUPPI: The Approach of the New Horizontal Merger Guidelines*, CRA COMPETITION MEMO, Aug. 31, 2010, at 2, [http://www.crai.com/sites/default/files/publications/Commentary-on-the-GUPPI\\_0.pdf](http://www.crai.com/sites/default/files/publications/Commentary-on-the-GUPPI_0.pdf).

<sup>246</sup> The GUPPI on Product *A* would consist of:

$$\frac{\text{The Value of Sales Diverted to Product } B}{\text{Foregone Revenues on Lost Product } A \text{ Sales.}}$$

The value of sales diverted to Product *B*, the numerator, is equal to the number of units diverted from Product *A* to Product *B* times the profit margin (price minus marginal cost) on Product *B*. The foregone revenues on lost Product *A* sales, the denominator, is equal to the number of lost Product *A* sales times the price of Product *A*. Thus, the fraction set forth above is equal to:

$$\frac{\text{Number of Product } A \text{ Sales Diverted to Product } B \times \text{Unit Margin on } B}{\text{Number of Product } A \text{ Sales Lost} \times \text{Price of Product } A.}$$

This, in turn, equals:

$$\frac{\text{Number of Product } A \text{ Sales Diverted to Product } B}{\text{Number of Product } A \text{ Sales Lost}} \times \frac{\text{Price of Product } B - \text{Marginal Cost of Product } B}{\text{Price of Product } A.}$$

See generally *id.* at 2–4 (explaining how to measure GUPPI).

separate GUPPI for Product *A* and for Product *B*). The Guidelines themselves do not specify how high the GUPPI for a particular product must be before competitive concerns are raised, but prominent proponents of the Guidelines' approach have suggested that a GUPPI of less than 5 percent would suggest an absence of adverse unilateral effects, whereas a GUPPI greater than 10 percent should be taken to create a rebuttable presumption of adverse unilateral effects.<sup>247</sup>

Though the GUPPI is a potentially powerful tool for evaluating competitive effects, its prominence in the 2010 Horizontal Merger Guidelines—especially when coupled with the guidelines' deemphasis of market definition—threatens to create significant error costs. As an initial matter, the simplistic-sounding GUPPI turns out to be difficult to calculate in practice. Take the final formula set forth in footnote 246. Calculating the fraction on the left—the so-called “diversion ratio”<sup>248</sup>—requires enforcers to determine both the “own-price” and “cross-price” elasticities of demand for the products under consideration.<sup>249</sup> Although economists often estimate demand curves (from which they may derive elasticities of demand), doing so is not easy, and estimates are fraught with error.<sup>250</sup>

Enforcers are also likely to err in calculating the fraction on the right side of the final formula in footnote 246 (that is, the profit margin on the product to which sales are diverted, divided by the price of the product whose sales are diminished). Calculating profit margins requires estimating marginal cost (that is, the cost of producing one additional unit), which is notoriously difficult to measure. Standard accounting measures do not capture information on marginal cost. Whereas average variable cost (AVC)—the sum of non-fixed costs associated with producing the seller's total output, divided by the number of units produced—is easier to calculate and often serves as a proxy

<sup>247</sup> *Id.* at 2 (“... [A] GUPPI of less than 5% would be reasonably treated as evidence that ‘the value of diverted sales is proportionately small’ and hence that the proposed merger is unlikely to raise unilateral effects concerns. In contrast, it seems likely that a GUPPI of 10% or more would suggest more significant competitive concerns.”); Carl Shapiro, Update from the Antitrust Division, Remarks as Prepared for the ABA Section of Antitrust Law Fall Forum 24 (Nov. 18, 2010) (“Current division practice is to treat the value of diverted sales as proportionately small if it is no more than 5% of the lost revenues.”).

<sup>248</sup> The Diversion Ratio for Product *A* to Product *B* equals the number of Product *A* sales diverted to Product *B* divided by the number of Product *A* sales lost. In other words, it is the percentage of lost Product *A* sales that are recaptured by the merged firm in the form of Product *B* sales.

<sup>249</sup> “Own-price elasticity of demand” reflects the degree to which the quantity demanded of a product drops as its price rises. That measure must be assessed to determine the denominator of the Diversion Ratio (that is, the number of *A* sales lost). “Cross-price elasticity of demand” reflects the degree to which an increase in the price of one product increases the quantity demanded of a substitute product. That measure must be assessed to determine the numerator of the Diversion Ratio (that is, number of Product *A* sales diverted to Product *B*).

<sup>250</sup> See Dennis W. Carlton, *Revising the Horizontal Merger Guidelines*, 10 J. COMPETITION L. & ECON. 1, 25–26 (2010) (discussing “difficulties with measurement of diversion ratios”).

for marginal cost, using that measure here would be troubling. AVC tends to be lower than marginal cost over the relevant range of output, so using AVC to determine the profit margins on products to which sales are diverted (that is, price minus AVC) will tend to overestimate profit margins and, accordingly, exaggerate upward pricing pressure.<sup>251</sup> It seems, then, that reliance on the GUPPI as an initial indication of potential anticompetitive effect will generate significant errors.

This is especially true because the GUPPI excludes two key considerations influencing the likelihood of adverse unilateral effects: efficiencies stemming from the merger and product repositioning.<sup>252</sup> Any upward pricing pressure resulting from the incentive of a merged firm to divert sales from one product to a higher-margin substitute should be balanced against merger-induced cost-savings that would put *downward* pricing pressure on one or more of the merged company's products. Indeed, the original upward pricing pressure model incorporated efficiencies as an integral part of the analysis, recognizing that without an offset for efficiencies—a “standard deduction” of sorts—application of the model would always indicate an adverse price effect.<sup>253</sup> The 2010 Guidelines, however, do not include an efficiencies credit in the initial calculation of upward pricing pressure. They instead relegate consideration of merger-induced efficiencies to a later analytical step under the standard efficiencies defense.<sup>254</sup> This is troubling, for, as explained below, the quantum of proof required to establish an efficiencies defense is greater than that necessary to create an inference of anticompetitive harm.<sup>255</sup> The 2010 guidelines also call for GUPPI to be calculated without regard to other market participants' efforts to “reposition” their own products (modify their characteristics) to more closely compete with the products subject to GUPPI, thereby reducing the profitability of price increases and moderating upward pricing pressure. Effectively a form of new entry, product repositioning tends to constrain GUPPI price increases.<sup>256</sup> Like merger-induced efficiencies, however,

<sup>251</sup> As Dennis Carlton has explained:

If one uses average variable cost as an approximation of marginal cost [in determining the profit margin on the product to which sales are diverted], then one runs the risk of overestimating margins (and market power), with the consequence that the UPP index will overestimate the incentive to raise prices post-merger, because average variable cost is often below marginal cost.

*Id.* at 16–17.

<sup>252</sup> See James A. Keyte & Kenneth B. Schwartz, “Tally-Ho!”: UPP and the 2010 Horizontal Merger Guidelines, 77 ANTITRUST L. J. 587, 629–30, 639–45, 648–49 (2011).

<sup>253</sup> *Id.* at 590–91, 648–49.

<sup>254</sup> 2010 Merger Guidelines, *supra* note 238, at 29–32.

<sup>255</sup> See *infra* notes 263–274 and accompanying text.

<sup>256</sup> See Jerry Hausman, Serge Moresi & Mark Rainey, *Unilateral Effects of Mergers with General Linear Demand*, 111 ECONOMICS LETTERS 119 (2011) (explaining how repositioning and entry tend to reduce the magnitude of potential price increases post-merger).

product repositioning is relegated to an afterthought under the 2010 Guidelines.<sup>257</sup>

In light of the difficulty of measurement and the exclusion, at least at the initial stage, of any consideration of merger-induced efficiencies or product repositioning, it is particularly troubling that the GUPPI embraced by the 2010 Horizontal Merger Guidelines has not been empirically verified. As economist Dennis Carlton observed, “[T]he use of UPP as a merger screen is untested; to my knowledge, there has been no empirical analysis that has been performed to validate its predictive value in assessing the competitive effects of mergers.”<sup>258</sup> This dearth of empirical evidence seems especially problematic in light of the enforcement agencies’ spotty track record in predicting the effects of mergers. Economist Craig Peters, for example, found that the agencies’ merger simulations produced wildly inaccurate predictions about the price effects of airline mergers.<sup>259</sup> Professor Carlton thus warns:

UPP is effectively a simplified version of merger simulation. As such, Peters’s findings tell a cautionary tale—more such studies should be conducted before one treats UPP, or any other potential merger review method, as a consistently reliable methodology by which to identify anticompetitive mergers.<sup>260</sup>

Establishing upward pricing pressure using the GUPPI is easier than defining a market, assessing market concentration, and analyzing other structural factors that have traditionally been considered in horizontal merger review. Accordingly, the 2010 Guidelines are likely to increase the number of merger challenges launched by the agencies. Veteran antitrust enforcers Joseph Simons and Malcolm Coate, for example, have noted that the 2010 Guidelines’ upward pricing pressure screen “identifies as potentially problematic far more mergers than would be challenged or even investigated under the enforcement standards that have existed for more than twenty years.”<sup>261</sup> That might be appropriate if there were a significant number of false negatives under the older approach. But the agencies have presented no evidence that that is the case. As James Keyte and Kenneth Schwartz have observed:

UPP would suggest condemning 7-to-6 mergers where margins would be considered moderate. These are mergers that almost certainly would have avoided enforcement in the past. We are unaware of any evidence from merger retrospectives or postmerger enforcement suggesting that most or many of those mergers, in fact, led to anticompetitive price increases.<sup>262</sup>

<sup>257</sup> See 2010 Merger Guidelines, *supra* note 238, at 27–29.

<sup>258</sup> Carlton, *supra* note 249, at 24.

<sup>259</sup> Craig Peters, *Evaluating the Performance of Merger Simulation: Evidence from the U.S. Airline Industry*, 49 J.L. & ECON. 627 (2006).

<sup>260</sup> Carlton, *supra* note 249, at 32.

<sup>261</sup> Joseph J. Simons & Malcolm B. Coate, *Upward Pressure on Price Analysis: Issues and Implications for Merger Policy*, 6 EUR. COMPETITION J. 377, 389 (2010).

<sup>262</sup> Keyte & Schwartz, *supra* note 251, at 629.



Keyte and Schwartz go on to observe that one of the most ridiculed merger challenges in history—the notorious *Von's Grocery* case—would have been appropriate under the 2010 Guidelines' approach:

... [The Guidelines'] UPP screen would have indicated upward pricing pressure [from the merger of Los Angeles supermarket chains Von's and Shopping Bag] even though the merged grocery store had less than a 10 percent market share. In other words, the UPP screen as incorporated in the Guidelines would have provided a basis to condemn a merger that clearly was not anticompetitive. In the real world, Vons' eventually became part of Safeway—the largest grocer in Los Angeles when *Von's Grocery* was decided—and the grocery market in Los Angeles remains intensely competitive today.<sup>263</sup>

At the end of the day, then, deemphasizing market definition and market concentration and instead premising merger challenges on upward pricing pressure measured by an index whose accuracy is questionable will likely raise error costs by increasing improper condemnations of procompetitive mergers.

## 2. *Asymmetric Treatment of Efficiencies and Potential Anticompetitive Harms*

By making it easier for the enforcement agencies to make their initial showing that a horizontal merger is likely to occasion anticompetitive harm, the 2010 Horizontal Merger Guidelines exacerbate a problem that has long existed in merger analysis: the quantum of proof required for the enforcement agencies to establish a merger's likely anticompetitive harms is less than that the merging parties themselves must produce to establish likely procompetitive benefits (that is, merger-induced efficiencies). That asymmetry creates a systematic bias toward condemnation of horizontal mergers and will tend to enhance error costs relative to an approach that evaluated potential anticompetitive harms and procompetitive benefits according to the same standards.

Horizontal mergers, like so many business activities, are competitive mixed bags. Any particular merger of competitors may impose some consumer harm by reducing the competition facing the merged firm. The same merger, though, may provide some consumer benefit by lowering the merged firm's costs and thereby allowing it to compete more vigorously—most notably, by lowering its prices. A merger policy committed to minimizing the consumer welfare losses from unwarranted condemnations of net beneficial mergers and improper acquittals of net harmful ones would afford equal treatment to claims of anticompetitive harm and procompetitive benefit, requiring each to be established by the same quantum of proof.<sup>264</sup>

<sup>263</sup> *Id.* at 630.

<sup>264</sup> See Daniel A. Crane, *Rethinking Merger Efficiencies*, 110 MICH. L. REV. 347, 386–387 (2011). (“If the government and merging parties were held to the same standard of proof... then, conceptually, harms and efficiencies would be given equal weight despite the different allocations of burdens of proof... [T]he first-order preference should be to treat harms and benefits symmetrically on an individualized basis and only make a systematic correction to the extent necessary in light of the system's actual experience with a principle of symmetry.”)

That is not how things work under the 2010 Horizontal Merger Guidelines. As explained above, by deemphasizing market definition and permitting adverse unilateral effects to be established using the GUPPI, the Guidelines make it fairly easy for enforcement agencies to prove likely anticompetitive harms from a merger of rivals.<sup>265</sup> By contrast, the merging parties must: (1) prove that any claimed efficiencies are “merger-specific” (that is, incapable of being achieved absent the merger);<sup>266</sup> (2) “substantiate” asserted efficiencies;<sup>267</sup> and (3) show that such efficiencies will result in the very markets in which the agencies have established likely anticompetitive effects.<sup>268</sup>

Those showings may be difficult to make. With respect to the first (merger-specificity), merging parties must be prepared to rebut assertions that their claimed efficiencies could have been achieved using all sorts of creative contracting. Although the Merger Guidelines maintain that the agencies “do not insist upon a less restrictive alternative that is merely theoretical,”<sup>269</sup> it is unclear which alternatives the agencies will deem impracticable.<sup>270</sup> With respect to the verifiability requirement, the agencies insist that merging parties prove “the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), [and] how each would enhance the merged firm’s ability and incentive to compete . . . .”<sup>271</sup> This is a much heavier proof burden than that facing the enforcers tasked with establishing potential anticompetitive effects. The last required showing—that the claimed efficiencies are likely to result in the same market experiencing anticompetitive effects—will be particularly difficult when the claimed harm is upward pricing pressure identified by the GUPPI. When the agencies assert that a merger will put upward pricing pressure on a brand-differentiated product (for example, Product *A*) because lost sales of that product are particularly likely to be diverted to a high-margin substitute also produced by the merged firm (for example, Product *B*), they are implicitly arguing that there is

<sup>265</sup> See *supra* notes 238–262 and accompanying text.

<sup>266</sup> 2010 Merger Guidelines, *supra* note 238, at 30 (“The Agencies credit only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects.”).

<sup>267</sup> *Id.* at 30 (“[I]t is incumbent upon the merging firms to substantiate efficiency claims . . .”).

<sup>268</sup> *Id.* at 30, n. 14 (“The Agencies normally assess competition in each relevant market assessed by a merger independently and normally will challenge the merger if it is likely to be anticompetitive in any relevant market.”).

<sup>269</sup> *Id.* at 30.

<sup>270</sup> See Dissenting Statement of Commissioner Joshua D. Wright in Memorandum Opinion & Order, *In re Ardagh Group S.A., and Saint-Gobain Containers, Inc., and Compagnie de Saint-Gobain*, F.T.C. File No. 131–0087, at 5 (Apr. 11, 2014) [hereinafter Wright *Ardagh* Dissent] (“While the Merger Guidelines assert that Agencies ‘do not insist upon a less restrictive alternative that is merely theoretical,’ there is little systematic evidence as to how this requirement is applied in practice.”).

<sup>271</sup> 2010 Horizontal Merger Guidelines, *supra* note 238, at 30.

a “market” consisting of these two brands.<sup>272</sup> Merger-induced efficiencies not involving those two brands would thus be “out of market” and might not be credited.<sup>273</sup> Taken together, then, the merger-specificity, verifiability, and “in market” requirements of the efficiencies defense place a much heavier proof burden on those attempting to show merger-induced efficiencies than on the enforcers seeking to establish likely anticompetitive harm.<sup>274</sup> This unbalanced scale is likely to generate significant Type I error costs.<sup>275</sup>

### 3. *Embracing Conduct Remedies Versus Embracing Structural Remedies in Merger Review*

A third merger-related development that may be inconsistent with a limits of antitrust approach is the enforcement agencies’ increased reliance on conduct remedies in merger cases. Traditionally, when an enforcement agency concluded that a merger was likely to lessen competition, it imposed a “structural” remedy—either an order that the merger not proceed or a command that the parties divest some portion of the businesses to be merged.<sup>276</sup> Enforcement of such a remedy was a simple matter; enforcers merely had to ensure that the parties did a single, discrete thing (that is, cancel their merger plans altogether or first sell off some line of business). In recent years, though, the agencies have

<sup>272</sup> See Carlton, *supra* note 249, at 20 (observing that when there is unilateral harm in the form of upward pricing pressure, “the logic of market definition in the ... Guidelines would indicate that the products of the two merging firms actually, by themselves, constitute a relevant market”).

<sup>273</sup> For a general argument against the “in market” requirement for crediting efficiencies, see Jan M. Rybníček & Joshua D. Wright, *Outside In or Inside Out?: Counting Merger Efficiencies Inside and Out of the Relevant Market*, in 2 WILLIAM E. KOVACIC: AN ANTITRUST TRIBUTE—LIBER AMICORUM (2014), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2411270](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2411270).

<sup>274</sup> See Crane, *supra* note 263, at 348 (“[A]s a matter of both verbal formulation in the governing legal norms and observed practice of antitrust enforcement agencies and courts, the government is accorded greater evidentiary leniency in proving anticompetitive effects than the merging parties are in proving offsetting efficiencies.”); Malcolm B. Coate, *Efficiencies in Merger Analysis: An Institutional View*, 13 SUP. CT. ECON. REV. 230 (2005) (observing that “the efficiency defense faces an impossibly high burden”); Wright *Ardagh* Dissent, *supra* note 269, at 4–7.

<sup>275</sup> The 2010 Guidelines’ asymmetric treatment of upward pricing pressure theories and asserted merger-induced efficiencies is particularly troubling when the merger at issue involves innovative firms with heavy research and development operations (e.g., pharmaceuticals, etc.). Such firms are particularly likely both (1) to enjoy high profit margins (price must exceed marginal cost because the fixed costs associated with R&D are huge), and (2) to experience significant cost reductions from merging operations. The first factor suggests that the GUPPI resulting from a merger of two such firms would be significant (so the government could easily establish likely adverse unilateral effects), but the second factor suggests large efficiencies could result from such a merger. If those efficiencies get a short shrift in the analysis, as is likely under the Guidelines’ approach, beneficial mergers in these industries are especially likely to be condemned.

<sup>276</sup> See William F. Shughart II & Diana W. Thomas, *Antitrust Enforcement in the Obama Administration’s First Term: A Regulatory Approach*, CATO INST. POL’Y ANALYSIS, Oct. 22, 2013, at 1, 2, [http://object.cato.org/sites/cato.org/files/pubs/pdf/pa739\\_web.pdf](http://object.cato.org/sites/cato.org/files/pubs/pdf/pa739_web.pdf).

taken to approving mergers on the condition that the parties follow some set of detailed conduct rules.<sup>277</sup> Unlike structural remedies, such conduct remedies require the enforcement agencies to engage in continual monitoring of the parties' behavior. They effectively transform antitrust enforcers into regulatory agencies and invite all sorts of problems associated with ongoing government regulation of business behavior.

The agencies' embrace of a regulatory approach to merger remedies is most evident in DOJ's 2011 *Antitrust Division Policy Guide to Merger Remedies* (the "2011 Remedies Guide").<sup>278</sup> That document replaced DOJ's 2004 Remedies Guide, which proclaimed that "[s]tructural remedies are preferred to conduct remedies in merger cases because they are relatively clean and certain, and generally avoid costly government entanglement in the market."<sup>279</sup> The 2011 Remedies Guide removed that statement, as well as the assertion that behavioral remedies would be appropriate only in limited circumstances. The 2011 Guide instead remained neutral on the choice between structural and conduct remedies, explaining that "[i]n certain factual circumstances, structural relief may be the best choice to preserve competition. In a different set of circumstances, behavioral relief may be the best choice."<sup>280</sup> The 2011 Guide also removed the older Guide's discussion of the limitations of conduct remedies.<sup>281</sup>

Not surprisingly in light of the altered guidance, several of DOJ's recent merger challenges—Ticketmaster/Live Nation, Comcast/NBC Universal, and Google/ITA Software, for example—have resulted in settlements involving detailed and significant regulation of the combined firm's conduct.<sup>282</sup> The

<sup>277</sup> *Id.* at 14.

<sup>278</sup> U.S. DEPARTMENT OF JUSTICE, ANTITRUST DIVISION POLICY GUIDE TO MERGER REMEDIES (June 2011), <http://www.justice.gov/atr/public/guidelines/272350.pdf>.

<sup>279</sup> U.S. DEPARTMENT OF JUSTICE, ANTITRUST DIVISION POLICY GUIDE TO MERGER REMEDIES § III.A (October 2004), <http://www.justice.gov/atr/public/guidelines/205108.htm>.

<sup>280</sup> 2011 Remedies Guide, *supra* note 277, at 4.

<sup>281</sup> The 2004 Guide had warned:

Conduct remedies suffer from at least four potentially substantial costs that a structural remedy can in principle avoid. First, there are the direct costs associated with monitoring the merged firm's activities and ensuring adherence to the decree. Second, there are the indirect costs associated with efforts by the merged firm to evade the remedy's "spirit" while not violating its letter. As one example, a requirement that the merged firm not raise price may lead it profitably, and inefficiently, to reduce its costs by cutting back on quality—thereby effecting an anticompetitive increase in the "quality adjusted" price. Third, a conduct remedy may restrain potentially procompetitive behavior. ... Fourth, even where "effective," efforts to regulate a firm's future conduct may prevent it from responding efficiently to changing market conditions. For all of these reasons, structural merger remedies are strongly preferred to conduct remedies.

2004 Merger Remedies Guide, *supra* note 278, § III.A.

<sup>282</sup> See Final Judgment, *United States v. Ticketmaster Entm't, Inc. and Live Nation, Inc.*, No. 10-cv-00139 (July 30, 2010), <http://www.justice.gov/atr/cases/f260900/260909.htm>; Final Judgment, *United States v. Comcast Corp., General Electric, and NBC Universal, Inc.*, No. 11-cv-00106 (Sept. 1, 2011), <http://www.justice.gov/atr/cases/f274700/274713.pdf>; Final

settlements have involved mandatory licensing requirements, price regulation, compulsory arbitration of pricing disputes with recipients of mandated licenses, obligations to continue to develop and support certain products, the establishment of informational firewalls between divisions of the merged companies, prohibitions on price and service discrimination among customers, and various reporting requirements.<sup>283</sup> Settlements like these move antitrust a long way from the state of affairs described by then-professor Stephen Breyer, who wrote in his classic book *Regulation and Its Reform*:

[I]n principle the antitrust laws differ from classical regulation both in their aims and in their methods. The antitrust laws seek to create or maintain the conditions of a competitive marketplace rather than replicate the results of competition or correct for the defects of competitive markets. In doing so, they act negatively, through a few highly general provisions prohibiting certain forms of private conduct. They do not affirmatively order firms to behave in specified ways; for the most part, they tell private firms what not to do . . . . Only rarely do the antitrust enforcement agencies create the detailed web of affirmative legal obligations that characterizes classical regulation.<sup>284</sup>

At least in the merger arena, Breyer's observations are no longer accurate.

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Judgment, United States v. Google, Inc. & ITA Software, Inc., No. 11-cv-00688 (October 5, 2011), <http://www.justice.gov/atr/cases/f275800/275897.pdf>.

<sup>283</sup> See generally Shughart & Thomas, *supra* note 275, at 14–17 (summarizing conduct remedies in Ticketmaster/Live Nation, Comcast/NBC Universal, and Google/ITA Software mergers). In the Comcast/NBC Universal merger, for example, the defendants were required to: (1) provide all NBC's video programming to requesting programming distributors on terms that were "economically equivalent" to those offered other distributors; (2) agree to have "economic equivalence" determined via arbitration if they could not agree on terms with a requesting distributor; (3) relinquish voting and veto rights over HULU (in which NBC owned a 32 percent interest) and establish an informational firewall between their joint venture and HULU; and (4) refrain from behavior considered to discriminate against Internet service providers. *Id.* at 16. Google and ITA Software were required to: (1) honor existing contracts for ITA's QPX software product (used by Internet travel sites that could compete with Google), renew those licenses under similar terms, and offer licenses to online travel sites on fair, reasonable, and nondiscriminatory terms; (2) continue to develop upgrades to QPX, investing the same resources in research and development as ITA had; (3) license InstaSearch, a QPX add-on that enabled customers to enter more flexible inquiries; (4) adhere to a strict internal firewall that would prevent information on QPX licensees from being available to Google for use in its own travel search operations; and (5) report complaints from online travel search competitors who accused Google of acting unfairly in displaying flight search advertising. *Id.* at 17. Ticketmaster and Live Nation were: (1) "prohibited from retaliating against venue owners that enter into contracts with a competing ticketing agency;" (2) "barred from conditioning the scheduling of live entertainment events in a particular venue on the use of [their] own ticketing platform by the same venue;" (3) "prohibited from conditioning the provision of ticketing services to a venue on their simultaneous delivery of live entertainment events;" (4) required to create and maintain "a firewall blocking the disclosure of client ticketing data to employees of other branches of the Ticketmaster/Live Nation business entity;" and (5) required to "disclos[e] . . . ticketing data to clients who chose to terminate their contracts with the newly merged company." *Id.* at 15–16.

<sup>284</sup> STEPHEN BREYER, *REGULATION AND ITS REFORM* 156–57 (1982).

How the move to regulatory merger remedies cuts from a limits of antitrust perspective is somewhat unclear. On the one hand, if imposition of conduct remedies liberates procompetitive mergers that otherwise would have been barred outright, the trend toward greater use of such remedies may reduce overall error costs. By offering enforcers a less restrictive regulatory option—some middle ground between permitting the merger unconditionally and banning it or ordering divestment—conduct remedies could facilitate mergers that provide net benefits to consumers but raise concerns that cannot be addressed through divestiture. It appears, however, that conduct remedies are being used not to liberate otherwise banned mergers but to increase regulation of mergers that otherwise would have been approved unconditionally. The three mergers discussed above, for example, were all vertical mergers (that is, mergers not of competitors but of firms that are in some sort of buyer-supplier relationship). Recognizing that vertical mergers are generally procompetitive, antitrust enforcers have in recent decades cut back on challenges to such mergers.<sup>285</sup> It is likely that the greater availability of conduct remedies will reverse this trend.

That is troubling, for conduct remedies present at least four difficulties from a limits of antitrust perspective. First, they may thwart procompetitive conduct by the regulated firm. When it comes to regulating how a firm interacts with its customers and rivals, it is extremely difficult to craft rules that will ban the bad without also precluding the good. For example, requiring a merged firm to charge all customers the same price, a commonly imposed conduct remedy, may make it hard for the firm to serve clients who impose higher costs and may thwart price discrimination that actually enhances overall market output.<sup>286</sup> Second, conduct remedies entail significant direct implementation costs. They divert enforcers' attention away from ferreting out anticompetitive conduct elsewhere in the economy and require managers of regulated firms to focus on appeasing regulators rather than on meeting their

<sup>285</sup> See, e.g., Deborah L. Feinstein, *Editor's Note: Are the Vertical Merger Guidelines Ripe for Revision?*, 24 ANTITRUST 5 (2010).

<sup>286</sup> As the 2004 Remedies Guide explained,

[A] conduct remedy may restrain potentially procompetitive behavior. For instance, a requirement that the merged firm not discriminate against its rivals in the provision of a necessary input can raise difficult questions of whether cost-based differences justify differential treatment and thus are not truly discriminatory. Firms often sell to a wide range of customers, some of which have very intense demands for the product and would be willing to pay a high price based on that demand and others of which are not willing to pay nearly so much. When this is the case, and when price discrimination is feasible, permitting the firm to charge low prices to customers that have a low demand for the product and higher prices to customers that have a high demand for the product can increase not only the firm's profits, but total output and consumer welfare as a whole. Requiring the firm to charge a single price to all may, in such circumstances, result in a price that excludes the low demand group entirely.

2004 Remedies Guide, *supra* note 278, § III.A.

customers' desires.<sup>287</sup> Third, conduct remedies tend to grow stale. Because competitive conditions are constantly changing, a conduct remedy that seems sensible when initially crafted may soon turn out to preclude beneficial business behavior.<sup>288</sup> Finally, by transforming antitrust enforcers into regulatory agencies, conduct remedies invite wasteful lobbying and, ultimately, destructive agency capture.<sup>289</sup>

In the end, these drawbacks likely outweigh any benefits from deterrence of anticompetitive conduct. As William Shughart and Diana Thomas have observed, "supervising compliance has been a backwater for the attorneys and economists employed by the federal antitrust agencies," most of whom "do not want to be involved with ensuring compliance with court orders—job assignments that rarely make headlines."<sup>290</sup> Accordingly, detailed conduct remedies often do not achieve their stated ends, while still imposing significant costs. Their increased use seems inconsistent with a limits of antitrust approach.

## V. CONCLUSION

Antitrust is an inherently limited enterprise. If it reaches either too far or not far enough, consumers will suffer. If policy makers seek to minimize mistakes by increasing the complexity of the liability rule, business planners and adjudicators will face higher decision costs. Antitrust's inevitable—and inexorable—error and decision costs collectively comprise its limits.

<sup>287</sup> Shughart & Thomas, *supra* note 275, at 13 ("[T]o the extent that time and resources must be devoted to compliance matters, the enforcement authorities and the courts are deflected from their state mission of ferreting out and prohibiting possible antitrust law violations elsewhere in the economy—and the owners and managers of private firms are diverted from their primary goal of efficiently satisfying their customers' needs.").

<sup>288</sup> *Id.* ("[B]ecause behavioral remedies are based on assumptions about competitive market conditions at a point in time, they are static and fail to predict the ways in which competition may evolve in the future, or may lock the affected firms into technological or behavioral patterns that restrict their freedom to adapt to changing market conditions.").

<sup>289</sup> As John Kwoka and Diana Moss have observed,

[T]he increased interaction between large private companies and government enforcers necessitated by behavioral remedies could increase the risk that the antitrust agency is "captured" by the economic interests of the merging parties. While U.S. antitrust agencies have been commendably free of such influence, it should be recognized that for the antitrust agencies, there is little glory in compliance, but for the merged company, the incentives are quite different. Finding ways around the harsher aspects of a consent order may be worth a great deal to the client, who can justify expending significant resources on minimizing its impact on profits. Merging parties might therefore lobby in settlement proceedings for certain types of behavioral remedies because they allow the merged firm to more easily pursue profit-maximizing behavior.

John E. Kwoka & Diana L. Moss, *Behavioral Merger Remedies: Evaluation and Implications for Antitrust Enforcement*, American Antitrust Institute 35 (2011), [http://www.antitrustinstitute.org/sites/default/files/AAI\\_wp\\_behavioral%20remedies\\_final.pdf](http://www.antitrustinstitute.org/sites/default/files/AAI_wp_behavioral%20remedies_final.pdf).

<sup>290</sup> Shughart & Thomas, *supra* note 275, at 13–14.

The Roberts Court and the federal enforcement agencies have taken strikingly different stances on the limits of antitrust. The Roberts Court has generally respected them, crafting rules designed to minimize the sum of error and decision costs and thereby maximize antitrust's social value in light of its inherent limitations. The Agencies, by contrast, seem skeptical of the very existence of antitrust's limits.

What is the reason for this divergence? An obvious explanation turns on the institutional features of federal courts versus agencies. Generalist judges, who regularly confront cases across the legal spectrum, are aware of the limits of their expertise and, in light of their life-tenure and limited opportunities for advancement, have no obvious need to expand their turf. Agency staff, by contrast, are constantly reminded of—and rewarded for—their specialized expertise, and they tend to gain both prestige and financial rewards as their authority expands. Their natural tendency is to expand the law's reach.

Regardless of the cause of the diverging stances on the limits of antitrust, two things are clear. First, recent enforcement agency policies are in severe tension with the philosophy that informs Supreme Court antitrust jurisprudence. Second, if the agencies do not reverse course, acknowledge antitrust's limits, and seek to optimize the law in light of those limits, consumers will suffer.



